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**RUSSIA'S NATIONAL INTERESTS TOWARDS THE
CAUCASUS: IMPLICATIONS FOR GEORGIAN
SOVEREIGNTY**

by

David Z. Papava

June 2004

Thesis Advisor:
Second Reader:

Anne L. Clunan
Anna Vassilieva

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IMPLICATIONS FOR GEORGIAN SOVEREIGNTY**

David Z. Papava
Civilian, Ministry of Defense, Georgia
B.A., Department of History, Tbilisi State University, Georgia. 1997

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**NAVAL POSTGRADUATE SCHOOL
June 2004**

Author: David Z. Papava

Approved by: Anne L. Clunan
Thesis Advisor

Anna Vassilieva
Second Reader (Monterey Institute of International Studies)

James J. Wirtz
Chairman, Department of National Security Affairs

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ABSTRACT

This thesis explores the causes of Russian foreign policy towards Georgia. It argues that the Russian Federation continues to pursue a policy which weakens the sovereignty of the Caucasus. The main priority of this thesis is to identify why the Russian Federation seems to be pursuing a set of policies that economically and politically weaken the sovereignty of Georgia. Therefore, this thesis examines the forces and factors of Russian domestic politics that drive Russian national interests towards the Caucasus. The analysis focuses on one particular issue-area: the role of the economic elite in shaping Russia's domestic and foreign policies vis-à-vis the state in the electricity sector. In focusing on the energy policies of the Russian Federation, this thesis reveals the negative consequences for Georgia's sovereignty that result from a strong Russian influence in the region. This thesis analyzes how Russian national interests towards Georgia challenge the latter to establish autonomous decision-making with regard to its foreign policy and to exercise its own authority through an exclusive competence in internal affairs of the state. In conclusion, this thesis offers policy prescriptions on how Georgia might best preserve its sovereignty with respect to the Russian Federation in terms of energy dependency.

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I. INTRODUCTION

This thesis explores in depth the causes of Russian foreign policy towards the Caucasus that seem to weaken Georgian sovereignty. Therefore, this thesis examines the forces and factors of Russian domestic politics that shape Russia's national interests in the Caucasus region and analyzes how these interests are translated into the policy of bilateral affairs between the Russian Federation and Georgia. In focusing on the energy policies of the Russian Federation, this thesis reveals the negative consequences for Georgia's sovereignty that result from a strong Russian influence in the region. The scope of this thesis covers the last ten years of Russian statehood, but the bulk of analysis focuses on the current presidential administration's policies since the year 2000.

As a result of the collapse of the Soviet Union, Russia lost most of its ability to maintain the status of hegemonic challenger vis-à-vis the West. Nevertheless, despite Russia's temporary weakness, it remains an important player in international politics and is able to exercise its power worldwide in various ways.

As a strong regional power, Russia possesses the ability to impose its will on weaker neighboring states. Specifically, one of the most important factors shaping socio-economic and political developments in Georgia is the influence of neighboring Russia. Even after the dissolution of the Soviet Union, the Russian Federation preserves its strong influence in the Caucasus through its military presence in the region and the economic dependence of sovereign states (Georgia, Armenia) on Russian energy supplies (gas, electricity). This dependency has negative consequences for Georgia's ability to exercise state authority internally and pursue an effective self-governing foreign policy towards the West, the two key measures of Georgia's sovereignty.

Today, independent Georgia is on its way to integration into the transatlantic community. Georgia seeks membership in all major international organizations, including NATO and OSCE. The state is in the process of adopting democratic values and transforming to a full market-based economy. Georgia is a very active member of the Partnership for Peace Program and successfully implements NATO's Interoperability Objectives for its military forces, which are necessary to meet Western standards.

Without the proper encouragement, support, and interest of Western society, the achievements already in place would not have been possible. However, challenges caused by Russian expansionist policy towards the region have negative implications on the efforts of the international community to help successfully integrate sovereign Georgia.

Thus, a thorough understanding of the nature of Russian national interests in the Caucasus and especially in Georgia will help facilitate a goal of generating an effective long-term political strategy of the West vis-à-vis Georgia. Simultaneously, it will contribute to the development and successful implementation of Georgian foreign policy goals regarding its closest neighbor, with the ultimate result of solving major controversial issues and shaping mutually beneficial relations.

The main priority of this thesis is to identify why the Russian Federation seems to be pursuing a set of policies that economically and politically weaken the sovereignty of the Caucasus. Therefore, it examines what factors drive Russian national interests towards the Caucasus and how these interests result in the policy of weakening the Georgian state. The analysis of causal factors focuses on one particular issue-area: the role of the economic elite in shaping Russia's domestic and foreign policies vis-à-vis the state in the energy sector.

This thesis argues that even if the Russian Federation is currently oriented towards adopting the democratic values of western society and prioritizing its economic needs over the great power ambitions, it simultaneously continues to pursue a policy which effectively weakens the sovereignty of the Caucasus. Whether the causes of existing Russian policy towards the Caucasus are the leaders' perceptions of the threat, domestic power-struggles of the political bureaucracies, or vested interests of the economic elite, maintenance of strong influence in the region is the primary Russian national interest. Therefore all major policies, including economic cooperation in the field of strategic sectors, such as gas and electricity supply, have a negative effect on the political and economic institutions in the region. Russia's influence over Georgia radically contradicts the goals set by the current Georgian leadership: a) to preserve the integrity and sovereignty of the state; and b) to become a fully integrated member of the international community. In order to prevent the escalation of the negative tendencies for

Georgia caused by the existing Russian policy towards Georgia, the issue needs the urgent attention of decision makers both in Georgia and the international community.

Before turning to the overall design of the thesis, the concept of sovereignty is developed in order to provide the reader with a baseline for understanding the impact of Russian policy in Georgia, and more broadly in the Caucasus. Sovereignty is a broad term and implies multiple legal connotations that tend to be interpreted differently depending on the particular context and circumstance to which they refer. State sovereignty is most commonly referred to as the state's ability to make independent decisions concerning the issues of domestic and foreign policies, without external influence by any other actor of international politics. The state is the primary actor of international relations (IR) having international legal personality, or "a legal capacity possessing both entitlements and obligations arising under international law." In this capacity the state is sanctioned to conduct relations with other actors of IR according to several principles that include the "[r]espect for fundamental sovereignty and integrity."¹

In conducting relations with each other, the basic principle of international law is that "[a]ll states are entitled to equality"² and therefore the interaction between them in any organizational or institutional form should be based on "the principle of the sovereign equality of all its Members."³ But what does it actually mean for the state to be sovereign? As addressed by international law, the primary feature of national sovereignty indicates one's ability to act independently under the constraints of "the universally adopted and currently valid rules of international law."⁴ It is the "exclusive right of a State to govern the affairs of its inhabitants – and to be free from external control . . . A State possesses sovereignty when it is able to act independently of the consent or control of any other State."⁵

¹ William R. Slomanson, *Fundamental Perspectives on International Law*. 4th Edition. Wadsworth, Thomson Learning, Inc. 2003. p. 53.

² Slomanson, *Fundamental Perspectives on International Law*. P. 81.

³ United Nations, "Charter of the United Nations." Article 2.1. Online. Available at: <http://www.un.org/aboutun/charter/index.html>. Accessed May 3, 2004.

⁴ Slomanson, *Fundamental Perspectives on International Law*. p. 214.

⁵ Ibid., p. 214.

The ability to act independently concerns certain principles, among which the territorial principle is essential in recognizing national sovereignty of the state. The “State possesses the exclusive right to the use of its territory and to exclude other nations from being present without its consent.”⁶ Accordingly, when one state asserts its presence within another state’s territorial boundaries without the consent of the latter or through political mechanisms of enforced consent, has to be considered as violation of the main principles of sovereignty.

Another important arena of state sovereignty is the economy. Circumstances that violate the state’s sovereignty through economic activities are not precisely defined by international law. It is acknowledged that trade, for example, is the “key method for raising revenue and exercising some degree of political power. . . [It] creates wealth that in turn facilitates other advances.”⁷ At the same time international law recognizes that increased economic interactions among the states strengthen political ties and thus lead to long-lasting peace. Certainly, most of the issues that might be considered violations of state sovereignty through economic activities are regulated through international trade and financial regimes (World Trade Organization, International Monetary Fund etc.), as well as regional economic associations, but in general, it seems that if otherwise articulated by the contracting parties, the national legislation prevails during economic transactions between the two states.⁸

As much as it is the subject of international law, the issue of state sovereignty (or national sovereignty) is also inseparable from politics. “Despite the juridical sovereignty of virtually every modern state, hierarchical political authority is also a pervasive phenomenon in international politics.”⁹ Above all, actual practice of sovereignty in the international relations “reveals the failure to recognize that the norms and the rules of any international institutional system, including the sovereign state system, will have limited

⁶ Ibid., p. 247.

⁷ Ibid., p. 614.

⁸ For the detailed analysis of economy and international law, see Slomanson, *Fundamental Perspectives on International Law* pp. 613-672.

⁹ Alexander Wendt, and Daniel Friedheim, “Hierarchy Under Anarchy: informal empire and the East German state.” in Thomas J. Biersteker and Cynthia Weber eds. *State Sovereignty as Social Construct*. Great Britain, Cambridge: Cambridge University Press, 1996. p. 240.

influence and always be subject to challenge.”¹⁰ Sovereignty defines types of relationships between the states as primary actors in the international system, and therefore violation of sovereignty is a matter of interpretation under international relations.

In general, “[t]he notion of sovereignty rests on an overall congruence among authority, capability, territoriality, and loyalty.”¹¹ The state should be able to spread its authority and to achieve the loyalty of its citizens within the state boundaries, excluding any type of intervention from the outer world. In classic terms, a truly sovereign state should be able to exercise “the monopoly of the legitimate use of physical force within a given territory.”¹² According to Krasner, state sovereignty has been used in four different connotations. The term refers to either “the organization of public authority within a state and to the level of effective control exercised by those holding authority; . . . the ability of public authorities to control transborder movements; . . . the mutual recognition of states or other entities; . . . and the exclusion of external actors from domestic authority configurations.”¹³ Sovereignty is an ultimately combination of factors indicating how effectively the state performs its authority and maintains control over its subjects. “States have sovereignty to the extent that they have exclusive authority over their territories. In the modern states system this authority is usually differentiated into internal and external sovereignty.”¹⁴

In the world of anarchy, “the international system is characterized by power asymmetries.”¹⁵ Each state possesses relative power vis-à-vis the other states. Stronger states have more capabilities and therefore often greater desire to utilize their power,

¹⁰ Stephen D. Krasner, *Sovereignty: Organized Hypocrisy*. Princeton, NJ: Princeton University Press, 1999. p. 3.

¹¹ R.B.J. Walker and Saul H. Mendlovitz eds., *Contending Sovereignities: Redefining Political Community*. Boulder, Colorado: Lynne Rienner Publishers, 1990. p. 63.

¹² Max Weber, “Politics as a Vocation,” in H.H. Gerth and C. Wright Mills eds., *From Max Weber: Essays in Sociology*. New York: Oxford University Press, 1946. p. 78.

¹³ Krasner, *Sovereignty: Organized Hypocrisy*. p. 9.

¹⁴ Alexander Wendt, and Daniel Friedheim, “Hierarchy Under Anarchy: informal empire and the East German state.” p. 240.

¹⁵ Krasner, *Sovereignty: Organized Hypocrisy*. p. 6.

whether military, economic, political, or any other. In contrast, weak states are often under subjugation and in a constant struggle for survival.

Even though the violation of sovereignty may not take the direct form of annexation or occupation by military means, indirect violations, such as pursuing policies of economic dependency or supporting separatist regimes within the weaker state are most likely to take place. This includes outside intervention into the state's domestic power composition, when stronger states "reconfigure domestic authority structures in other states, accepting their juridical independence but compromising their de facto autonomy."¹⁶ Power asymmetries among the states, dual use of the notion of sovereignty, and capabilities of stronger states to influence weaker ones, give lie to the basic principles of international law under the UN Charter, on the equality of all states.

A. DESIGN OF THE THESIS

In order to provide a comprehensive analysis of the issue, the research uses an in-depth single case study methodology. In particular, it examines the causes of existing Russian policy towards the Caucasus and analyzes domestic factors driving Russian foreign policy towards Georgia with regards to the energy supplies. The case study examines how Russian national interests towards the Caucasus are translated into economic policy and analyzes the recent framework agreements between the Russian Federation and Georgia in the field of energy supply. This thesis analyzes why the Russian Federation seems to have a national interest in weakening the sovereignty of the Caucasus states, particularly Georgia, and what the impact of existing Russian expansionist policy on Georgia's sovereignty is. In addressing these questions, this thesis presents the views of the interested parties, and offers policy prescriptions on how to reduce Georgian dependency on Russian energy supplies.

This thesis uses a variety of primary and secondary sources including books, journal publications, newspaper articles as well as personal interviews with scholars and politicians in Georgia. The core of the research is based on a wide range of primary sources that became available through a research trip to Georgia in November 2003. There the author interviewed Georgian politicians, members of the Government of

¹⁶ Ibid., p. 7.

Georgia, scholars, and representatives of non-governmental organizations. With the permission of the Georgian government, the author also received copies of official documents and agreements concerning the relationships of the Russian Federation and Georgia in the energy sector. In addition, this thesis extensively uses original Georgian and Russian publications regarding regional politics in the Caucasus, current reforms of the Russian electricity sector, its impact on Russia's foreign energy policy, and detailed examination of the Georgian energy sector. These publications were received from the Georgian Foundation of Strategic and International Studies and the office of the Chairman of the Energy Regulatory Commission of Georgia in Tbilisi and are not generally available to the Western reader. Tremendous support in preparing questionnaires for interviewees and shaping the agenda for the trip was received from the thesis advisor and the second reader at the Department of National Security Affairs of the Naval Postgraduate School and Monterey Institute of International Studies, respectively. The trip was generously co-funded by the United States Army National Guard Bureau and the Naval Postgraduate School.

Chapter II of this thesis analyzes the causes for existing Russian policy towards Georgia. It introduces the debates on Russia's national interest and elaborates domestic factors that traditionally shape Russian foreign policy. Emphasis is drawn on Russian leadership politics, bureaucracies and interest groups, including military and the security services, the issue of Russia's borderland, and the economic actors. The chapter points to the changing perception of power in the Russian Federation from traditional sources, such as military capabilities, to alternative sources of power, such as energy.

In order to articulate relative strength and weakness of the state from the standpoint of energy security, the chapter presents a model of categorizing a state's energy sector. This model presents the states with the import-dependent, self-sufficient, and export oriented energy sectors. Each of the categories has various connotations in terms of threats posed to state sovereignty. Through the policies of energy dependency, the chapter argues, Russia threatens economic security of its relatively weak neighboring states, including Georgia, and attempts to violate its sovereignty.

The third chapter examines Russian factors in Georgian politics since the dissolution of the Soviet Union. The chapter first elaborates upon Georgia's political history during the last decade. It examines the politics of the Georgian leadership since 1991 and until the 'Revolution of Roses' in November 2003, when the former president of Georgia Eduard Shevardnadze resigned due to strong political resistance and overwhelming civil disobedience triggered by fraudulent parliamentary elections. The chapter stresses Russia's role in recent political processes in Georgia and argues that to a certain extent Russia helped to pacify the situation inside Georgia and avoid bloodshed and civil war. Even though there are no clear indications for the causes of Russian behavior with regards to political turmoil in Georgia at the end of 2003, the chapter presents several views on the subject. In particular, according to these views, political turmoil in Georgia happened either with Russian consent, because the change of the regime served Russia's interests; or because Russian policy with regards to Georgia was a result of the series of miscalculations; or, finally, because Georgia granted certain concessions to Moscow in exchange for Russia's pacifist role during the Rose Revolution.

Either way, the chapter suggests, Russian national interests in Georgia prevent the latter from becoming a sovereign state, fully integrated into the transatlantic community. Georgia, as Russia's weaker neighbor, has to remain under within Russia's domain. Dominance over Georgia's assets, the chapter argues, enables Russia to pursue its interests further south, towards Turkey and the Middle East. From this standpoint the Russian electricity sector serves as the tool for Russian expansionist foreign policy.

Such complexity in current intercourse between the Russian Federation and Georgia results in controversies over the status of Russian military troops in Georgia, Russia's war on terrorism in Chechnya, Russia's support to Georgia's breakaway regions of South Ossetia and Abkhazia, the role of Russian peacekeepers in the Caucasus region, and finally, Russian politics of energy with regards to Georgia. The last section of the chapter briefly elaborates Georgia's energy sector and discusses the circumstances under which Russian energy conglomerates acquired a considerable share of the Georgian energy market in 2003.

The fourth chapter of this thesis focuses on the Russian electricity sector. The goal is to reveal whether Russian foreign energy policy is determined by the state as a whole, by Russian domestic power-struggle between the bureaucracies, by vested interests of the economic elite in the Russian Federation, or by the combination of all three. First, the chapter gives a general overview of economic players in Russian electricity sector. It describes the main challenges for the Russian electricity sector at the beginning of the 1990s to survive in the industry and to adapt to new market-based relationships. The next section of the chapter presents perceptions of Russian leadership regarding the electricity sector in Russia. This is followed by an analysis of the domestic politics of the economic elite in the Russian electricity sector and the role of RAO Unified Energy System of Russia, the largest monopoly in the electricity sector in integrating the post-Soviet space. The state and the economic elite have different agendas in Russian domestic and foreign energy policies. The state seeks to regain ownership over the industry, but at the same time the Russian leadership recognizes the political benefits that liberalization of the electricity sector is about to bring. In order to formalize relationships with the economic elite, the state developed a regulatory framework for state control of the sector. The chapter analyzes relevant laws regarding the Russian electricity sector and its prospects of future development. Through the analysis, the chapter makes the following conclusion: the legislation directly reflects the overall trend of the Putin Administration to orient Russia's domestic and, more importantly, foreign policy towards achieving core economic objectives.

Chapter IV also analyzes the goals of the economic elite in Russia's electricity sector. Seventy percent of electricity generated in Russia belongs to the RAO UESR, which holds one of the leading places among the world's largest electricity companies and, together with Gazprom, is the largest monopoly in energy supplies. Recently the RAO UESR launched fundamental reforms. The chapter concludes that controversies in the issues of the state's role in regulating and controlling the electricity sector and the basic timelines of reforming the electricity sector still exist and active government intervention into the electricity sector has several negative effects for the electricity

industry. As a result, in order to preserve their business, in the trend in contemporary Russia is for key economic players to decrease their role in domestic politics and for the state to take control.

In contrast, confrontation between the state and the economic elite on foreign policy goals and export priorities are less evident than in the domestic politics. The state policy of economic expansion and its claim for the right to acquire regional energy markets is beneficial for both the state and economic players. While the goals are different, implementation policies remain the same: through exercising control over its weaker neighbors, the state seeks political influence. The economic elite, in turn, is interested in gaining profit.

In the last chapter, through examination of the case of the Russian electricity sector, this thesis explains why the Russian Federation pursues its national interests towards Georgia and analyzes how these interests challenge the latter's ability to: a) establish autonomous decision-making with regard to its foreign policy and b) exercise its own authority through an exclusive competence in internal affairs of the state. The chapter starts by introducing debates regarding the role of Russian energy policies towards Georgia. In particular, it elaborates Russian views regarding the ownership of the energy sector in Georgia; US concerns over the Georgian energy sector; and the Georgian response to the sale of the energy sector. These three sections present both positive and negative opinions regarding Russian dominance over the energy market in Georgia. Overall, the combined goals of the state and the economic elite of the Russian Federation yield joint Russian policies that violate Georgian sovereignty. Arguably, according to international law, there is no direct violation of Georgian sovereignty through Russian dominance on the Georgian energy market. The challenge for Georgian statehood is the balance of political forces within the Russian federation, which currently enables the state to use energy policy to seek power abroad. Based on the model of categorizing the state's energy sector given in the second chapter, the concluding section of chapter five offers policy prescriptions on how Georgia might best preserve its sovereignty with respect to the Russian Federation in terms of energy dependency.

II. CAUSES FOR EXISTING RUSSIAN POLICY TOWARDS THE CAUCASUS

Common knowledge suggests that ever since the breakup of the Soviet Union, Russia, through a foreign policy that attempts to defend Russian national interests abroad, has been constantly violating the sovereignty of its former satellite countries, including Georgia. Even if such a statement is true, it is important to realize four interconnected themes of the subject: the nature of Russian national interests; domestic factors driving Russian foreign policy; an understanding of the causal mechanisms and the actual policy instruments that Russia applies domestically in order to pursue its interests abroad and violate Georgia's sovereignty; and particular interpretation of the term sovereignty when used in the context of relationships between the Russian Federation and its weaker neighbors. Recognition of how and why this chain of factors comes into being and how these factors interact with each other helps to create a broader understanding of current regional political processes.

When one has to put under strict terminological constraints a notion of national interest, particularly Russian national interest which, as commonly argued, lacked consistency and continuity throughout the decades of the Soviet existence, the realist definition given by Francis Fukuyama is useful. He refers to the 'proper' understanding of national interest as "the maximization of a nation's power and influence to preserve its own autonomy, delinked from any overtly ideological foreign policy goals."¹⁷ Even if explored with such concise terminological jargon the definition does not explain the causal mechanism between national interest and foreign policy of the state. That is, it does not explain why the state in given circumstances behaves in a particular way.

Often, formulated policy options do not necessarily reflect a state's efforts to preserve its national interest and therefore "national interests certainly exist but usually take a minimal role and are not terribly useful in defining a nation's foreign policy."¹⁸ The basic problem with the inconsistency in the state's effort to preserve its national

¹⁷ Francis Fukuyama, "The Ambiguity of 'National Interest'," in Stephen Sestanovich eds., *Rethinking Russia's National Interests*. Washington D.C.: Center for Strategic and International Studies. 1994. p. 11.

¹⁸ Fukuyama, "The Ambiguity of 'National Interest'." p. 11.

interest through continuous foreign policy is associated with two main variables. First is the nature of international relations that shapes the state's behavior towards other actors of international politics. The second variable driving the state's behavior internationally is purely domestic and largely depends on power distribution within the state. Various forces and factors that shape the domestic power structure of the state simultaneously influence foreign policy design and to a certain extent have an effect on national interests. Interaction of these two variables, in most cases (including Russia), fills the existing gap between foreign policy and national interest. It helps to understand the reasoning behind the state's conduct with regards to the other actors.

A. DOMESTIC FACTORS OF RUSSIAN FOREIGN POLICY

Russia's behavior with regards to the outside world is an outcome of a complex interdependence of domestic factors that interact with the state to influence the formation of Russian foreign policy. It is "a product of the interaction between domestic politics and the external environment that provides the context for the activities and nationalist ambitions of domestic actors."¹⁹ There are number of domestic factors worthy of attention, which include but are not limited to: Russia's leadership politics; bureaucratic and interest groups in Russia; Russia's borderland; and economic actors shaping Russian foreign policy.²⁰ These factors have been consistently present in Russian foreign policy priorities since the Soviet Union and play a similarly important role in shaping Russian perceptions to the outer world at present.

Leadership politics – are normally associated with the leaders' perceptions of the threats posed to Russian security. A highly centralized, vertically oriented "strong power centre is characteristic of Russian political culture, as is the allocation of power to leading personalities rather than institutions."²¹ It is the president, his administration, and the

¹⁹ Leszek Buszynski, "Sources of Russian Foreign Policy after the Cold War." *Slavic Review*, Vol. 56, No. 3. Autumn 1997. p. 584.

²⁰ See for example: Celeste A. Wallander eds., *The Sources of Russian Foreign Policy After the Cold War*. Harvard University Russian Research Center: Westview Press, 1996; Neil Malcolm, Alex Pravda, Roy Allison and Margot Light, *Internal Factors in Russian Foreign Policy*. Oxford: Oxford University Press, 1996; Office for Official Publications of the European Communities, Forward Studies Series. *Shaping Actors, Shaping Factors in Russia's Future*. New York: St. Martin's Press, 1998.

²¹Office for Official Publications of the European Communities, Forward Studies Series. *Shaping Actors, Shaping Factors in Russia's Future*. New York: St. Martin's Press, 1998. p. 3.

government that “constitute the most influential center of power in the country . . . They set the objectives for both the internal and external policies of Russia.”²²

Bureaucratic and interest groups – are associated with more traditional sources holding power in Russia. These are primarily the military and the security institutions that have “begun to exert a significant though uncoordinated influence on the formation of foreign policy, especially in relation to the ‘near abroad’.” Since the military and security structures are traditional sources of power on which initially the Soviet Union and later the Russian Federation placed their bet in their superpower ambitions, it is commonly argued that they “have gained additional political influence by default.”²³

Russia’s borderland – is probably the most sensitive topic in the Russian polity since the dissolution of the Soviet Union. Russian geopolitics has its roots in Tsarist Russia of the nineteenth century.²⁴ Even now, Russia’s reliance on its vast territories plays a tremendous role in the formulation of foreign policy. There are three basic models of territorial composition: the revisionist model, stressing Russia’s role as an imperialist power, where it is ‘doomed’ to be an empire” and eventually will restore “domination over the entire Soviet/imperial space and the adjacent traditional spheres of influence;”²⁵ the model of Russia’s disintegration, which favors “a reduction to Russia’s Slavic core [and] focus on rebuilding what is left of Russian culture and lands;”²⁶ and the creative adjustment model that reaffirms the need for the Russian Federation to orient its foreign policy towards the west, free its political mentality from the traditional ‘imperial’

²² Katarzyna Petczyńska-Natcz, “Who Rules Russia and How?” in Janusz Bugajski and Marek Michalewski, eds. *Toward an Understanding of Russia*. New York: Council of Foreign Relations, 2002. p. 2. Online. Available at: <http://www.ciaonet.org/book/buj01/buj01_01.pdf>. Accessed June 7, 2004.

²³ Roy Allison, “Military Factors in Foreign Policy,” in Neil Malcolm, Alex Pravda, Roy Allison and Margot Light. *Internal Factors in Russian Foreign Policy*. Oxford: Oxford University Press, 1996. pp. 230-231; see also Pavel K. Baev, *The Russian Army in a Time of Troubles*. Oslo, Norway: International Peace Research Institute. SAGE Publications. 1996.

²⁴ See for example: Nikolai Danylevskii (1822-1885), *Russia and Europe*. 1869. Published online, August 2000. Available at: <<http://www.kulichki.com/~gumilev/DNY/index.html>>. Accessed June 7, 2004.

²⁵ Dmitri Trenin, *The End of Eurasia: Russia on the Border Between Geopolitics and Globalization*, Washington DC: Carnegie Endowment for International Peace, 2002. p. 305.

²⁶ Anne L. Clunan, “Chapter 3: Russian National Self-Images in the 1990s,” in *Identity and the Emergence of National Interests in Post-Soviet Russia*, Ph.D. dissertation, August 2001, p.137.

tendencies, as well as great power ambitions, and concentrate on the economic needs of the state.²⁷

Economic actors – have been an emerging force in Russia since the breakup of the Soviet Union. By the middle of the 1990s new economic elites, the oligarchs, accumulated their capital and power to the level that they became a fully competing force in making Russia's foreign policy.²⁸ As much as Russia, in its economic development, largely relies on the export of energy commodities, "[the] significance of Russia's vast natural resources, and especially energy resources, to Russian energy and foreign policy cannot be overemphasized."²⁹ The Russian energy sector is "the part of the economy that has the greatest contact with the international economy." At the same time the state recognizes the importance of the Russian energy sector as an instrument of its foreign policy. As it is commonly argued, "it is hard not to suspect that Russia is using energy resources as an instrument of broader foreign policy goals."³⁰

Perceptions of power in Russia change. Current trends show the shift from traditional sources of power, such as military strength, to economic policies. In accordance with the general wisdom, throughout this thesis, the concept of 'power' is understood as a "type of causation" that implies an idea of "who is influencing whom with respect to what."³¹ Accordingly, the source of power is explained as the tool for one actor of international politics to impose its economic, political, and military interests on another actor. Such a pattern of behavior assumes that one state, willingly or not, violates the sovereignty of another state. Russia, in order to gain international influence in the Commonwealth of Independent States (CIS), increasingly uses economic policies of dependency-creation instead of conventional reliance on its military capabilities.

²⁷ Trenin, *The End of Eurasia*. 2002. p.p. 308-330.

²⁸ On the subject of the emergence of oligarchic groups see for example: David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia*. New York: Public Affairs. 2002.

²⁹ Jurgis Vilemas, "Russia's Energy Policy," in Janusz Bugajski and Marek Michalewski, eds., *Toward an Understanding of Russia*. New York: Council of Foreign Relations, 2002. p. 45. Online. Available at: <http://www.ciaonet.org/book/buj01/buj01_04.pdf>. Accessed June 7, 2004.

³⁰ Matthew Evangelista, "From Each According to Its Abilities: Competing Theoretical Approaches to the Post-Soviet Energy Sector," in Celeste A. Wallander eds., *The Sources of Russian Foreign Policy After the Cold War*. Harvard University Russian Research Center: Westview Press, 1996. pp. 173, 185.

³¹ David A. Baldwin, "Power Analysis and World Politics: New Trends versus Old Tendencies." *World Politics* 31, 2. January 1979, pp. 161-162.

If the concept of power in Russia is changing, then the response of those concerned about their sovereignty vis-à-vis Russian intentions should change as well. If Russia, in its intentions, increasingly relies on alternative sources of power, such as the policies of economic dependency, Georgia, in response, should build its security institutions and design its foreign policy in a way that deters new challenges with regards to Russian intentions. Russia's shift in its sources of power towards the policies of economic dependency represents a threat to the economic security of the sovereign states, which are currently the members of the CIS. But what is economic security? What are the factors indicating threats to the economic security of the state? And how crucial is economic security for the survival of sovereign state?

B. ENERGY SECTOR AS A THREAT INDICATOR TO ECONOMIC SECURITY

Economic security is an indispensable part of a state's national security. When overall security is interpreted as "the condition of safety of vitally important interests of the individual, the society, and the state from internal and external threats," economic security should guarantee that these interests are achieved through overall economic stability and prosperity. In particular, national security "is provided through implementing the unified state policy with a system of measures of economic, political, organizational, and other natures" that adequately deters perceived internal and external threats to the individual, society, and the state.³² Therefore, economic security should ensure that policy makers are provided with sufficient financial, material, and other types of resources in order to guarantee successful implementation of the national goals. In the modern world of mutual interdependence, no state is able to achieve full independence from the rest of the world in terms of its economic development, but certain types of indicators determine whether economic security, and thus the overall national security structure of the given state, is significantly affected by either internal or external factors.

One of the indicators of the level of threat posed to economic security is the country's energy sector. To the extent that use of energy resources is of crucial importance to the development of modern industrial society, adequate supply determines

³² Security Council of the Russian Federation. "Law of the Russian Federation on Security." Article 1, Article 4. Adopted December 12, 1993. Online. Available at: <<http://www.scrf.gov.ru/Documents/2646-1.html#sb>>. Accessed January 8, 2004. [Translated by author].

whether the state is economically secure, or vulnerable to either internal or external influences. “The concept of energy security implies a constant, guaranteed, and economically attainable supply of energy resources to each individual in sufficient quantities and adequate qualities.”³³ The more secure the state is in its energy supplies, the less vulnerable it is to threats of an economic, political or military nature. Therefore, in modern society the energy sector is an important source of power, and effective sovereignty in the issues of energy policy – the state’s ability to make the most effective and efficient choices among those available (this equally evolves both economic and political considerations) largely determines the sustainability of a state’s overall national security structure.

In general, this thesis focuses on Russia’s energy sector, but does so only through analysis of the electricity sector. The energy sector best represents a shifting perception of the Russian power base from traditional sources such as military strength to new, alternative sources of power, such as economic expansion. Currently Russia, in its economic growth, largely relies on exports of energy products and therefore dedicates tremendous efforts to create a convenient political climate both within the Russian Federation and outside its borders, and in the world energy markets. The primary export commodities of Russian energy resources are natural gas and oil. A considerable literature has been written on the importance of these commodities for Russia’s economic growth and the impact of Russian export policies on the sovereignty of its relatively weak post-Communist neighbors. The field of Russia’s interests in terms of exporting natural gas and oil are well-studied.

Electricity, on the other hand, constitutes a relatively small share of Russian exports. Throughout the last decade exported quantities of electricity did not exceed five percent of the generated product (See: Figure 1, Chapter IV). Therefore, often either there is a lack of interest in studying Russia’s electricity sector as the component of the particular source of power, or the audience automatically assumes that the state is using the electricity sector for the sake of its own interests abroad.

³³ Demur Chomakhidze, *Georgian Energy Security: Social and Economic Aspects*. Tbilisi, Georgia: Melkadze Scientific Research Institute of Social, Economic, and Regional Problems 2003. p. 14. [Translated by author].

There is a divided opinion regarding the role of the electricity sector in Russian politics: some assume that electricity serves the same device for a Russian politics of imperialism as natural gas, oil, and other traditional sources of power; others believe that the electricity sector does not play any role in Russian politics, either domestically or abroad; in addition, there is a view that the Russian electricity sector does play a role in Russian polity, but only in domestic affairs. If conducting business internationally, economic players in the field act on behalf of their own interests.³⁴

Seemingly, the Russian electricity sector has less importance for the Russian state in terms of its capabilities to influence political processes over the CIS space, but this statement does not correspond to the truth and is misleading. The electricity sector plays the same role in Russia's aggressive economic policies vis-à-vis the CIS as natural gas and oil. Russia exercises the same level of political leverage over its weaker neighbors, including Georgia, through the electricity sector as it does by natural gas and oil elsewhere. Often, misleading assumptions concerning the role of the electricity sector in Russian foreign policy is owed to a well-developed legal basis that the state was able to enact during the last few years and ongoing reforms of Russia's largest monopoly in the electricity sector, the RAO Unified Energy System of Russia. Therefore, later chapters of the thesis analyze relevant laws in the electricity sector and importance of structural changes in RAO UESR.

This thesis introduces three general categories to describe the energy sector of the state: import-dependent, self-sufficient, and export-oriented. Each of the categories has various connotations in terms of threats posed to state sovereignty and with regard to the relationships between the Russian Federation and Georgia; each of them have a different likelihood of appearance. An import-dependent energy sector is poorly supplied with energy resources and is not able to provide sufficient quantities of fuel and energy products by exploring domestic resources and thus largely relies on imports. A self-sufficient energy sector can generate a minimum supply of energy products for domestic consumption, but for further requirements, or because of the needs of economic efficiency, has to seek imports of fuel and energy resources from abroad. Finally, an

³⁴ The thesis examines in detail views regarding the role of the electricity sector in Russian politics in chapters IV and V.

export-oriented energy sector is well-supplied with domestically produced fuel and energy resources. In this case the sector is able to produce, transmit, and dispatch sufficient quantities of energy products for domestic consumption to the extent that companies involved in the business concentrate their activity on export priorities.³⁵

This thesis applies this method of categorizing the energy sector to the relationships between the Russian Federation and Georgia. At present, Georgia is not capable of producing sufficient quantities of energy products for domestic consumption and Russian companies are the main suppliers to the Georgian market. Therefore, the concept of 'export-oriented' versus 'import-dependent' energy sector is assigned to the Russian Federation and Georgia, respectively.

States tend to form their foreign policy in a way that provides adequate diplomatic tools in order to defend their national interests abroad. In particular, one of the most important foreign policy goals for states with an import-oriented energy sector is to politically secure guaranteed and reliable imports of fuel and energy supplies, while maintaining a competitive environment for potential and existing foreign export companies. In contrast, states that are well-supplied with domestic fuel and energy resources are more oriented towards creating the political environment that facilitates long-term export projects for domestic companies.

In general, this type of approach suggests that big economic players in states with an export-oriented energy sector tend to influence formation of foreign policy goals that aim to acquire and dominate particular regional markets. Such a trend creates a win-win situation both for economic players and for the state. If the former seeks economic profits through expansionist foreign policy, the state, in turn, gains an opportunity to extract economic resources from economic players domestically, in order to safeguard political aspirations abroad.

Normally, "economic measures threatening the economic security of the state include boycott, embargo, or blockade. While all these measures can be introduced

³⁵ For further discussion on the subject see: "Energy Security: Problems of Functioning and Development of the Electricity Sector," in V. A. Barinov, V. V. Bushuev, E. P. Volkov eds., *Russian Security: Legal, Socio-Economic and Scientific/Technical Aspects*. Moscow: MGF Znanie, 2001. p.6-7. [Translated by author].

against any country . . . [for the state that is highly dependent on the import of energy resources] . . . these measures are extremely risky as far as domestic capabilities and the ability to mobilize internal resources is very limited.”³⁶ With regard to the relationships between two countries this concept is expressed in the attempts of one state to influence the political and economic institutions of another state. In our case the supplier of energy resources (the export-oriented energy sector of Russia) attempts to maintain a monopoly and dominance over the energy markets of importers of the product (the import-dependent energy sector of Georgia). Therefore Georgia’s ability to make independent decisions concerning its energy policies is considerably reduced by Russian influence and this factor by itself is a violation of Georgia’s sovereignty.

Once introducing political situation in Georgia and evaluating main issues at stake between the Russian Federation and Georgia, subsequent chapters of this thesis further develop the argument regarding Russia’s expansionist foreign policy through its electricity sector and the impact of Russian behavior on Georgia’s sovereignty.

³⁶ Alexander Rondeli, *Small State In The International System*. (Tbilisi, Georgia: Mecniereba 2003), p.95 [Translated by author].

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III. RUSSIAN FACTOR AND POLITICS IN GEORGIA DURING THE LAST DECADE

The last decade of the Georgian history witnessed a continuous struggle for restoring territorial integrity, attempts for economic revival, and defending sovereignty of the Georgian state. Despite recent modest positive developments, efforts to deal with internal problems in Georgia remain unsuccessful. It was only after the ‘Revolution of Roses’ in November 2003, when the new Georgian leadership took power that the state authorities managed to restore a jurisdiction of central authority in Adjara autonomous region. Nevertheless, the breakaway republics of Abkhazia and South Ossetia still hold de facto independence. Hundreds of thousands of internally displaced persons (IDPs) are not able to return to their homes. The state authorities in Georgia have trouble controlling internal borders in Pankisi Gorge and Kodori Valley. Despite the dissolution of the Soviet Union, Russia maintains two military bases on the Georgian soil and the CIS Peacekeeping forces in Georgia’s breakaway regions. State institutions inside the country remain weak. The economy, although growing slowly, is devastated. Even with its sufficient potential capacity for domestic energy generation, Georgia depends on foreign powers in its energy supplies and constantly experiences energy shortages. These shortages affect a development of local industry and cause social unrest within the state. Additionally, corruption remains the main obstacle in implementing progressive reforms in any sphere.

Two main factors contributed to these failures throughout the last decade: improper policies of the Georgian leadership, stemming from the first independent government of Georgia in 1990-1991, and great power interests in the region. The main criticism is directed towards former President of Georgia Eduard Shevardnadze. Instead of undertaking political and diplomatic efforts in order to solve Georgia’s domestic problems, there seems to be a firmly held opinion within the Georgian state that the former president directed his endeavors towards preserving personal power. He thereby created the type of paternal institutions that were based on the values of personal loyalty to the regime, rather than the rule of law. Such behavior contributed to Georgia’s weak and corrupted institutions, which in turn became one of the major causes of state

weakness.³⁷ Throughout the decade Russian influence in the region has been extremely strong and in large measure, Georgian weakness is attributed to Russian policies in the Caucasus region. Up until now, relationships between the two countries remain tense. Despite the Georgian Prime Minister Zurab Zhvania's recent statements that these relationships have turned a "absolutely new" page with "mutual confidence and more cooperation in various spheres," the majority of accumulated problems during the last decade remain unresolved."³⁸

A. A DECADE OF POLITICAL TURMOIL IN GEORGIA

Referring to the unanimous will of the Georgian population expressed during the popular referendum of March 31, 1991, the Supreme Soviet of the Georgian Republic "based on the Act of Independence of May 26, 1918, stipulates and publicly declares the restoration of independence of the Georgian statehood."³⁹ The official declaration of Georgian independence followed on April 9, 1991. After the dissolution of the Soviet Union in December 1991, the newly independent Georgian state struggled against political, economic, and social disintegration. Georgia's first president, Zviad Gamsakhurdia, was elected on May 26, 1991. He pursued aggressive nationalist policies that facilitated further deterioration of the local state of affairs. Continuously mounting opposition within the country accused him of dictatorship and antagonistic nationalism.⁴⁰ Controversies over domestic policies accelerated to the point that at the end of 1991 and beginning of 1992 Georgian Government and the opposition confronted each other in an armed conflict. As a result of the civil wars, Gamsakhurdia was overthrown in January 1992. In March of that year the Georgian Military Council invited Eduard Shevardnadze, former foreign minister of the Soviet Union, to become the provisional leader of the

³⁷ Dr. Alexander Rondeli, President of the Georgian Foundation For Strategic and International Studies (GFSIS). Tbilisi, November 11, 2003. Interviewed by author.

³⁸ "Press Conference With Georgian Prime Minister Zurab Zhvania," *The Federal News Service, Official Kremlin Int'l News Broadcast*. May 25, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 26, 2004.

³⁹ "Act of Restoration of State Independence of Georgia," Tbilisi, April 9, 1991. Naval Postgraduate School, Monterey, CA. [Translated by author].

⁴⁰ See: Mort Rosenblum, "Protests Against Georgia's President Intensify." *Associated Press*. Tbilisi, September 5, 1991. Online. Accessed through: <<http://www.nexis.com/research>>. May 25, 2004.

republic of Georgia, and in October the same year he was elected as speaker of the Georgian Parliament.⁴¹

President Shevardnadze's personal reputation contributed to his initial success in Georgian politics. He was the former Soviet Minister of Foreign Affairs and together with Mikhail Gorbachev, was one of the major reform communists who came to the conclusion that "it [was] no longer possible to live this way."⁴² Because of his reputation as a progressive thinking politician, a contributor of the Soviet demise, and for his personal contribution in the withdrawal of Soviet forces from East Germany, Shevardnadze enjoyed widespread western support. This was expressed in the form of Western foreign direct investments, the involvement of various international organizations and NGOs in Georgian politics, society and economics. At the same time, however, the domestic situation was not improving. Economic conditions were not improving; the social sector as not efficient; domestic political disputes over the breakaway regions of Abkhazia and South Ossetia were not solved; most of the country suffered electricity and heating shortages; and democratic reforms in most cases were delayed or disrupted.

In 1995 and in 2000 Eduard Shevardnadze was twice reelected as the President of Georgia. The last presidential elections reportedly were fraudulent and rigged.⁴³ His unpopularity grew because of the lack of effective economic, social, and political reforms. The population in general felt the burden of poor economic development, as well as social and political instability. Poverty among more than half the population, low incomes, and delay in payment of salaries and pensions remained important socio-economic problems that the Georgian government was not able to address.⁴⁴ During the later years of his presidency, Eduard Shevardnadze was criticized on numerous occasions for his unclear political course as well.

⁴¹ "Shevardnadze Elected Leader of Georgia," *Christian Science Monitor*. Tbilisi, October 13, 1992. Online. Accessed through: <<http://www.nexis.com/research>>. May 25, 2004.

⁴² Martin Malia, *The Soviet Tragedy*. New York: The Free Press, 1996. p. 411.

⁴³ See for example "Candidate says Georgia presidential election rigged," *Interfax News Agency*. Tbilisi, April 9, 2000. Online. Accessed through: <<http://www.nexis.com/research>>. May 26, 2004.

⁴⁴ In 2001, 54 percent of Georgian population remained under poverty level. Source: Central Intelligence Agency, "World Factbook 2003." Online. Available at: <<http://www.cia.gov/cia/publications/factbook/geos/gg.html>>. Accessed June 14, 2004.

Despite the fact that the official foreign policy course of Georgia remained integration into the Transatlantic and European security and economic structures, several decisions in particular were considered as proof of his pro-Russian orientation. These decisions primarily concerned his constant delay in requesting the replacement of Russian Peacekeeping forces in Georgia's breakaway region Abkhazia with a multinational peacekeeping contingent, his failure to resume the negotiating process with the South Ossetian and Abkhazian de facto separatist governments, and his encouragement of a Russian role as the main mediator in these negotiations. After the energy deals between AES and RAO UESR as well as Gazprom and the Georgian Government, the Shevardnadze several times had to deny allegations that Georgia was changing its pro-western foreign policy course.⁴⁵

2003 was a crucial year in the decade of Georgian political turmoil. The domestic political opposition, as well as the international community placed special emphasis on the parliamentary elections, scheduled for November 2nd. The issue of having powerless legislative body was also extremely important for the former President of Georgia. The opposition political parties, led by a coalition of Mikheil Saakashvili (leader of the National Movement), Nino Burjanadze (the Parliamentary Chairperson) and Zurab Zhvania (head of the Burjanadze-Democrats alliance) expressed their strong unease regarding the possibility that Shevardnadze's regime could rig parliamentary elections by influencing the Central Election Commission (CEC), falsifying election results, and manipulating the voters' lists.⁴⁶

The international community shared these concerns. President Shevardnadze's increasingly pro-Russian orientation facilitated these concerns and during the parliamentary election campaign, numerous statements were made by the international community regarding the importance of conducting free and fair elections in Georgia. The US administration sent a clear message to the government of Georgia, indicating that negative consequences would follow in the event of attempts by President

⁴⁵ See for example "Georgian president reaffirms loyalty to pro-Western course," *BBC Worldwide Monitoring*. Source: Georgian Radio. Tbilisi, August 11, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 28, 2004.

⁴⁶ Detailed insights are available on the UNA-Georgia Online Magazine Civil.ge, at: <<http://www.civil.ge/eng/>>. Accessed May 28, 2004.

Shevardnadze's regime to influence election results. As former Chairman of the US Joint Chiefs of Staff John Shalikashvili has put during his visit in Tbilisi in October 2003, not only the US, but all other western countries "will review their attitude towards Georgia if the elections are rigged."⁴⁷ Georgia's European partners were also concerned with the upcoming parliamentary elections in Georgia. The Organization for Security Cooperation in Europe (OSCE) dedicated some 450 observers, an unusually high number, from 18 OSCE member countries in order to ensure free and fair conduct of the elections.⁴⁸

Expectations of the international community and the domestic political opposition in Georgia regarding the risk of rigging the parliamentary election process were confirmed. Multiple violations took place prior to and during the elections on November 2, 2003. The overall election process, according to international monitoring groups, lacked adequate transparency. The state authorities abused administrative resources and displayed political bias for the benefit of the ruling pro-presidential political bloc – For New Georgia. The Central Election Commission (CEC) was conducted its affairs in favor of the government: it repeatedly ignored proper counting procedures and was directly involved in producing dishonest election results for the benefit of Georgia's former president Eduard Shevardnadze. "A wide variety of shortcomings and irregularities were noted including direct observations of serious election fraud." Major violations included: ballot stuffing, multiple voting, destruction of ballot boxes, attempts to unduly influence voters, numerous and serious inaccuracies in voter lists, and identical signatures on them.⁴⁹

Extremely poor social and economic conditions of almost half of the Georgian population, fraudulent parliamentary elections, and continuously unstable and unbalanced policies of President Shevardnadze triggered street protests organized by the three

⁴⁷ "US delegation says attitude to Georgia may change if elections rigged," *BBC Worldwide Monitoring*. Source: Prime-News Agency. Tbilisi, October 7, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 28, 2004.

⁴⁸ "Presidential election in Georgia, 4 January 2004," ODIHR Election Observation Mission to Georgia, OSCE. Online. Available at: <http://www.osce.org/odihr/elections/field_activities/?election=2004georgia#1a>. Accessed May 28, 2004.

⁴⁹ See "Georgia: Parliamentary Elections November 2003," OSCE/ODIHR. Election Observation Mission Report, Part 1. Warsaw, January 28, 2004. p.p. 1-2, 16-20. Online. Available at: <http://www.osce.org/documents/odihr/2004/01/1992_en.pdf>. Accessed May 28, 2004.

opposition leaders: Mikheil Saakashvili, who would later become Georgian President, Speaker of the Parliament Nino Burjanadze, and Prime Minister Zurab Zhvania. The 'Rose Revolution,' as it was named later, seemed to many to be the spontaneous outcome of the events immediately following the November 2nd parliamentary elections. However, in an interview given later to the Time International, President Saakashvili affirmed that former political opposition in Georgia had long-standing goals and implementation mechanisms that were activated after the elections. "We'd been prepared for the past two years. It was obvious that Shevardnadze would go the oligarchic route of succession--the group around him would transfer power to someone who would guarantee their privileges and that would finally destroy Georgia. We started organizing this six months before the elections."⁵⁰ The eventual lack of compromise between the opposition and the government escalated the opposition demonstrations. Instead of calling for the initially planned boycott of the elections and requests to redo the parliamentary elections, from the middle of November 2003 the opposition solely concentrated on the resignation of President Shevardnadze.

Even though the attempt to overthrow the former president of Georgia was deliberately planned and backed up, as many believe, by western community, the risk of severe bloodshed was extremely high.⁵¹ From November 3 and until November 22, the Georgian state faced the uncertainty of civil war, disorder, and eventual disaster for the state. There was a strong likelihood that power ministries in Tbilisi might receive and execute the order to disperse massive street demonstrations in Georgian capital. Opposition leaders declared a state of "total civil disobedience throughout the country."⁵² The common fear among the population was that Shevardnadze might call for Russia's military assistance in order to preserve his personal power.

⁵⁰ "10 Questions for Mikheil Saakashvili," *Time International*. January 19, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 28, 2004.

⁵¹ For western involvement, especially the role that billionaire philanthropist George Soros during the 'Rose Revolution', see for example Gwynne Dyer, "Georgia: a question of legitimacy." *CanWest Global Communications*. January 11, 2004; Alexander Iashvili, "Soros's people came to power in Georgia." *RusData Dialine - Russian Press Digest*. Source: Izvestia, No 27, p.5. February 16, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 28, 2004.

⁵² "Georgian Opposition Declares "Total Civil Disobedience" To Authorities," *BBC Monitoring, International Reports*. November 14, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 28, 2004.

The fears of exploding violence and civil war did not come to pass. As a result of the resistance and overwhelming civil disobedience brought on by the opposition leaders, on November 23, 2003, President Shevardnadze and his government resigned. The Supreme Court of Georgia annulled the results of the November 2nd parliamentary elections. On January 4, 2004, in an extraordinary presidential election, Mikheil Saakashvili was elected the President of Georgia with 96% of the vote.⁵³ In March, new parliamentary elections were held where the majority of the seats went to the former opposition political parties.⁵⁴

One of the main priorities for new Georgian leadership became the issue of state reunification. The new President of Georgia repeatedly broadcast this message throughout the country. During the military parade dedicated to Georgian Independence Day on May 26, 2004, the president stated, “[o]ur goal is Abkhazia! Our goal is to defend our territories! Our goal is to let our enemies know – we want peace, but will not permit the disintegration of Georgia.”⁵⁵ This and other similar statements were made after the successful attempts of the Georgian government to change the regime in Georgia’s autonomous region of Adjara.

The policies of the new Georgian leadership in Adjara should be considered the most successful domestic achievement during the last decade. In short, former president of Georgia Eduard Shevardnadze and the leader of Adjara Autonomous Republic Aslan Abashidze were historical rivals during the last decade of Georgian statehood. During the parliamentary elections on November 2, 2003, both reunited their efforts in order to preserve their own power and defeat new Georgian opposition. Despite their tremendous efforts they lost and after the presidential inauguration in January 25, 2004, conflict

⁵³ During the election campaign three opposition leaders: Mikheil Saakashvili, current Prime Minister Zurab Zhvania, and Parliamentary Chairperson Nino Burjanadze united their efforts in a single presidential candidate. That explains the high percentage of votes for current President of Georgia.

⁵⁴ For the matter of presidential and parliamentary elections see “Georgia: Extraordinary Presidential Elections, January 4, 2004,” OSCE/ODHIR Election Observation Mission Report. Warsaw, February 28, 2004. Online. Available at: <http://www.osce.org/documents/odihr/2004/02/2183_en.pdf>. Accessed May 29, 2004; “Repeat Parliamentary Election, Georgia – 28 March 2004. Statement of Preliminary Findings and Conclusions,” OSCE, International Election Observation Mission. Online. Available at: <http://www.osce.org/documents/odihr/2004/03/2488_en.pdf>. Accessed May 29, 2004.

⁵⁵ “Our Goal – Abkhazia,” *Novosti – Gruzia News Agency*. Tbilisi, May 26, 2004. Online. Available at: <http://www.newsgeorgia.ru/news.html?nws_id=262868&date=2004-05-26>. Accessed June 4, 2004. [Translated by author].

between the central authorities in Tbilisi and the Adjarian leader escalated. In March, in response of Abashidze's refusal to allow the new Georgian president into the autonomous region to campaign on the eve of repeat parliamentary elections, the central authorities imposed an economic blockade around the renegade region. Meanwhile Abashidze actively conducted negotiations with authorities in Russia hoping to gain Russian support. Nevertheless, Georgia's diplomatic efforts with regards to Adjara's fate prevailed over the personal ambitions of Aslan Abashidze. On May 6, 2004, he stepped down and fled to the Russian capital immediately after meeting with the Secretary of Russian Security Council Igor Ivanov.⁵⁶

B. RUSSIA AND THE REVOLUTION OF ROSES IN GEORGIA

Russia was a participant in the recent political transformations in Georgia. During the November turmoil in Tbilisi and later resignation of Adjarian leader, current Secretary of Russian Security Council and former Minister of Foreign Affairs Igor Ivanov visited first Tbilisi and later Adjara's capital Batumi to mark the resignation of two former Georgian leaders. In both instances events developed in a similar way: although both leaders initially did not intend to leave their respective positions, after the meeting with the Russian emissary both Shevardnadze and Abashidze made the decision to compromise.

There have been no public statements regarding the exact role of Russian presidential administration in peacefully resolving the situation in Georgia. The only motivation for Russia's active role in the November 2003 Georgian crisis is the desire of Russian government to maintain peace and stability in a neighboring country. Nevertheless it seems that the current Georgian leadership recognizes Russia's positive role in averting the escalation of violent conflict during the Revolution of Roses and in procuring the later resignation of Aslan Abashidze. In an interview with the Russian daily '*Nezavisimaya Gazeta*', Georgian Prime Minister Zurab Zhvania stated that Russian foreign minister Igor Ivanov "played a tremendous role in peacefully resolving the crisis

⁵⁶ For More background on the issue of political turmoil in Adjara see for example: Jaba Devdariani, "De-Escalation in Adjara: Success For Georgia's New Government." *Central Asia-Caucasus Institute*. The Johns Hopkins University, Washington DC. March 24, 2004. Online. Available at: <http://www.cacianalyst.org/view_article.php?articleid=2224>. Accessed May 31, 2004; Nikolai Topuria, "Georgia takes control of renegade region, sets sights on two others." *Agence France Presse*. May 7, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 31, 2004.

and preventing bloodshed without the participation of [Igor] Ivanov it would be extremely hard to imagine the dialogue between the President Shevardnadze and the leaders of the opposition.”⁵⁷ The exact same statement is valid for the visit of Igor Ivanov to Batumi in May 2004. Here too it seems that after consulting with Secretary of Russian Security Council, Abashidze decided to resign despite his earlier public pledges not to do so.⁵⁸

Even though there is no clear indication of the real causes for Russian involvement in Georgia’s recent political turmoil, there have been number of speculations on the subject. In one view, Moscow “has allowed Tbilisi to take over Adjara following its own multi-purpose strategy for the Caucasus.”⁵⁹ The Russian government is concerned that a politically unpredictable and fully disintegrating Georgian state could become a heaven for terrorism and Chechen separatism. Therefore it is in Russia’s interest to keep Georgia politically weak and Russia-dependent, but at the same time relatively stable, with enough capabilities to prevent its full disintegration and the increasing dominance of non-state actors. Consequently, Russia contributed to peaceful resolution of the crisis in Georgia “only to avert the violence that was potentially dangerous to itself.”⁶⁰

Another view suggests that Russia made a series of miscalculations with regards to recent events in Georgia and the Putin administration had no other choice but to deal with current Georgian leadership.⁶¹ The Georgian presidential administration, according

⁵⁷ Zurab Zhvania, “We came with the ambition to make Georgia better.” *Nezavisimaya Gazeta*. November 28, 2003. Online. Available at: <http://www.ng.ru/cis/2003-11-28/1_zhvania.html>. Accessed May 31, 2004. [Translated by author].

⁵⁸ See for example Eka Mekhuzia, “Abashidze says no plans to resign or leave Adzharia.” *ITAR-TASS News Agency*. May 5, 2004; Alexandra Chebanu, Ivan Novikov, “Abashidze resignation not to lead to escalation of conflict.” *ITAR-TASS News Agency*. May 6, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 31, 2004.

⁵⁹ Pavel Baev, “Ajaria’s Failed Secession And Russia’s Caucasian Choices.” *Central Asia-Caucasus Institute*. The Johns Hopkins University, Washington DC. May 19, 2004. Online. Available at: <http://www.cacianalyst.org/view_article.php?articleid=2377>. Accessed June 1, 2004.

⁶⁰ Stephen Blank, “Georgia’s Revolution: Russia’s Sour Grapes.” *Central Asia-Caucasus Institute*. The Johns Hopkins University, Washington DC. December 3, 2003. Online. Available at: <http://www.cacianalyst.org/view_article.php?articleid=1947>. Accessed June 1, 2004.

⁶¹ See Baev, “Ajaria’s Failed Secession And Russia’s Caucasian Choices;” Igor Torbakov, “Saakashvili’s political punch prompts Kremlin to rethink policies.” *Open Society Institute, Central Eurasia Project*, New York. April 6, 2004. Online. Available at: <<http://www.eurasianet.org/departments/insight/articles/eav040604.shtml>>. Accessed June 1, 2004.

to this opinion, is increasingly pro-western. The Caucasus region after the defeat of Shevardnadze's regime in Georgia will shift in its foreign policy orientation towards the West and Georgia itself will emerge "as an outpost of Western influence in the Caucasus."⁶² This will increase the US influence in the region and harm Russia's national interests.

In addition, there is a strong opinion that Georgia has granted certain concessions to Moscow in exchange for Russia's pacifist role during the Rose Revolution and the Adjara crisis. Possible compromises include favorable economic policies, investments in Georgian energy sector, the status of Russian military bases in Georgia, and the guarantee that the current Georgian leadership will not attempt to restore Georgia's territorial integrity through forceful means.⁶³

C. RUSSIA'S NATIONAL INTERESTS TOWARDS GEORGIA: MAIN ISSUES AT STAKE

None of the views above alone reflects the full complexity of current relations between the Russian Federation and Georgia, but they do highlight the overall pattern of Russian – Georgian behavior and indicate the main issues currently at stake. A short historical overview of the turbulent coexistence between the two countries proves that "while verbally recognizing territorial integrity of Georgia, Russia attempts to use Georgian problems . . . in order to pressure Georgia towards implementing foreign policy that corresponds to Russian interests."⁶⁴ The common assumption within the Russian polity, shared by most of the leftist, centrist, and rightist political groups is that Georgia

⁶² Igor Torbakov, "Russia remains wary of Georgia's geopolitical intentions." *Open Society Institute, Central Eurasia Project*, New York. February 18, 2004. Online. Available at: <<http://www.eurasianet.org/departments/insight/articles/eav021804.shtml>>. Accessed June 1, 2004.

⁶³ See for example: Cory Welt, George Anjaparidze, "Georgian-Russian pipeline: for peace or profit?" *Open Society Institute, Central Eurasia Project*, New York. March 9, 2004. Online. Available at: <<http://www.eurasianet.org/departments/business/articles/eav030904.shtml>>. Accessed June 1, 2004; Sergei Blagov, "Saakashvili "Makes Friends" With Putin during Georgian Leader's Moscow Visit." *Open Society Institute, Central Eurasia Project*, New York. February 12, 2004. Online. Available at: <<http://www.eurasianet.org/departments/insight/articles/eav021204.shtml>>. Accessed June 1, 2004; Irakly Areshidze, "Did Russia and Georgia make a deal over Ajaria?" *Open Society Institute, Central Eurasia Project*. New York. May 19, 2004. Online. Available at: <<http://www.eurasianet.org/departments/insight/articles/eav051904.shtml>>. Accessed June 1, 2004.

⁶⁴ Alexander Rondeli, "Russia and Georgia: Asymmetric Neighborhood," in Boris Rumer eds., *Central Asia and the Caucasus: Existent Problems*. Alma-Ata, 2003. p. 112. [Translated by author].

as Russia's weaker neighbor has to stay within the orbit of Russian influence.⁶⁵ But Georgia's weakness and its dependency on Russia are not the desired end-state of Russian policy. Putin, as Pavel Baev notes, "is not playing the Georgia or even the Caucasus game . . . [President Putin's] internal power building takes precedence over all other activities, because Putin is aware that his performance in Brussels or Washington is dependent on his ability to control his own domain."⁶⁶ In other words, "Putin Administration must contend with domestic interest groups and constituencies in crafting policies."⁶⁷

Russia's aggressive policies with regards to Georgia must be explained by domestic and international concerns: Georgia is located in unsafe environment. It is a neighbor of Russia's North Caucasus regions (Chechnya) and control over domestic politics in Georgia largely determines how effectively Russia can manage its own southern tier. Georgia's geo-strategic location is also important with regards to Russia's relations with the outside world. Influence and direct ownership over Georgian assets allows Russia to implement a successful foreign policy towards Turkey and Iran. According to Alex Rondeli,

control over Georgia permits Russia to hinder Turkey from extending its influence over post Soviet Turkic republics and peoples; to distance Azerbaijan, the state rich in energy resources, from the West, by cutting the exit through Georgia to the Black Sea; to prevent the development of the Europe-Asia corridor, the transit route between Central Asia and Europe through the South Caucasus and maintain monopoly over transporting energy resources and other products from Central and East Asia to Europe; and keep a substantial military presence in the Black Sea region. Through control over Georgia and consequently over the South

⁶⁵ For in-depth analysis of internal composition of political parties and interest groups in Russia, as well as their beliefs regarding both Russian domestic and foreign policies see: Archie Brown eds., *Contemporary Russian Politics*. New York: Oxford University Press. 2001. pp. 49-99, 211-247, 345-369; Thomas F. Remington, *Politics in Russia*, 2nd ed. Addison – Wesley Educational Publishers, 2001. pp. 146-201; Anne L. Clunan, "Chapter 3: Russian National Self-Images in the 1990s," in *Identity and the Emergence of National Interests in Post-Soviet Russia*, Ph.D. dissertation, August 2001: pp. 111-139.

⁶⁶ Pavel Baev, "Russia's Virtual War Against Georgia: Risks of a PR Offensive." Center for Strategic and International Studies. PONARS Policy Memo No. 251. October 2002. p. 1. Online. Available at: <http://csis.org/ruseura/ponars/policymemos/pm_0251.pdf>. Accessed June 2, 2004.

⁶⁷ Nikolas K. Gvosdev, "The Sources of Russian Conduct." *The National Interest*, Spring 2004; 75. p. 31.

Caucasus Russia preserves the ability of acute influence in the Middle East.⁶⁸

The bottom-line requirement of Russian national interests in the Caucasus is that Georgia remains Russia's satellite. Even though Russia recognizes Georgian sovereignty and in many but not in all instances has to act in accordance with the practices of international law, there is a double standard in the Russian government's approach towards Georgian statehood. On the one hand there are official statements acknowledging non-discrimination and recognition. President Putin constantly stresses the principle of territorial integrity and sovereign statehood of Georgia. On the other hand there are Russian politicians, such as Konstantin Zatulin, who believe that "with all due respect to the [CIS] states, many of them are destined to become our satellites or die. Up to this extent I recognize their territorial integrity."⁶⁹

The absence of a general framework agreement between Georgia and the Russian Federation is the main challenge regarding the issue of Georgian sovereignty.⁷⁰ Throughout the last decade, several attempts to make an overarching agreement on cooperation between the Russian Federation and Georgia constantly failed due to anti-Georgian sentiments in Russian Duma. Only in 2002 did the sides begin negotiations in order to develop the general framework agreement on cooperation between the Russian Federation and Georgia. The agreement "ultimately has to establish the legal basis for the relationships between the two countries."⁷¹

There are numerous multilateral treaties under the framework of the Commonwealth of Independent States (CIS) and bilateral agreements between the two countries on a number of political and economic issues, but both parties have constantly violated most of them. The overall framework agreement should define the rights and

⁶⁸ Alexander Rondeli, "Russia and Georgia: Asymmetric Neighborhood." p.105. [Translated by author].

⁶⁹ Konstantin Zatulin, *Nezavisimaya Gazeta*. May 5, 1994. State Duma Deputy; Director of the Institute of the Commonwealth of Independent States. Initially quoted in Alexander Rondeli, "Russia and Georgia: Asymmetric Neighborhood." p. 107. [Translated by author].

⁷⁰ George Manjgaladze, Acting Deputy Defense Minister of Georgia. November 19, 2003. Interviewed by author.

⁷¹ Alexander Rondeli, "Russia and Georgia: Asymmetric Neighborhood." p. 109. [Translated by author].

responsibilities of Georgia and the Russian Federation. The document should become the guarantor of Georgia's sovereignty under international law and define responsibilities that the Georgian side must take in order to improve relationships with the Russian Federation. Most importantly, the general framework agreement must specify what concessions the Georgian state has to make to Russia; on what issues will it have to compromise; and which Russian interests in Georgia should be recognized as legitimate. Seemingly, the current leadership both in Georgia and in the Russian Federation realizes the need to formalize bilateral relations. An existing draft of the agreement is in most instances acceptable for Georgia, and as the next step, the leaders of the two countries plan to meet before 2005 to sign the agreement.⁷²

Without clear acknowledgement of Russian interests in the Caucasus region and particularly in Georgia, overall relationships with Russia will not improve. Increasing controversies between the two countries do not help the goal of strengthening Georgia's sovereignty. A visit by a high-ranking Georgian delegation to Moscow during late May of 2004 supports the view that state authorities in Georgia fully acknowledge the importance of their northern neighbor in dealing with Georgia's domestic problems. The BBC, referring to Russia's '*Kommersant*,' reported that in response to Georgia's request for Russia to compromise on the restructuring of 230 million USD debts in the energy sector,

Moscow . . . would like to resolve Georgia's debt problem by gaining possession of the infrastructure of Georgia's fuel and energy complex. But the main thing is that Moscow is planning political concessions - it would like to obtain an undertaking from Georgia that it will abandon its tight schedules for withdrawing Russian military bases from Georgian territory, that it will settle Tbilisi's relations with Abkhazia and South Ossetia exclusively by peaceful means, and also that it will acknowledge the Russian Federation's special interests in these unrecognized republics.⁷³

⁷² "Georgian-Russian framework agreement to be signed before year end – ambassador," *Interfax News Agency*. Moscow, April 22, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 26, 2004.

⁷³ "Georgian ministers in Moscow: talks focus on debt relief, energy, security," *BBC Worldwide Monitoring*. Moscow, May 26, 2004. Online. Accessed through <<http://www.nexis.com/research>>. May 26, 2004.

Such complexity of the contemporary situation between the Russian Federation and Georgia results in disputes over multiple subjects and constant controversial debates over the status of Russian military troops in Georgia; Russia's war on terrorism in Chechnya and questionable support of the former Georgian regime to Chechen separatists; Russia's support to Georgia's breakaway regions of South Ossetia, Abkhazia, and up to recently Adjara; the destabilizing role of Russian peacekeepers in the Caucasus region; and finally, Russian politics of energy in Georgia.

D. RUSSIA'S ENTRY INTO THE GEORGIAN ELECTRICITY SECTOR

Georgia's power generation is predominately hydroelectric, representing an extensive investment made during the era when the Soviet Union undertook a major expansion of its hydroelectric capabilities. After the collapse of the Soviet Union, Georgian rates of consumption, production and import of electricity drastically declined and by 2001 reached nearly half of the numbers produced back in 1992 (see figure 1). Financial limitations made imports of fuel and power increasingly difficult, and the Georgian electricity sector came to rely primarily on its own hydropower. Hydropower constitutes nearly 79% of the electricity balance of the country and, according to a study conducted by USAID and the Ministry of Fuel and Energy of Georgia, it will continue to play a major role in Georgia's energy plans for the foreseeable future.⁷⁴ Reliance solely on the domestic hydro resources has proved to be ineffective as a result of obsolete infrastructure and continuous mismanagement. The breakup of the Soviet Union and Georgia's subsequent economic hardship has limited the ability of Georgian electricity sector to maintain its generation, transmission and distribution facilities or to meet current load requirements. The lack of funds to rebuild or replace obsolete utilities and to purchase fuel and/or import power has resulted in serious energy shortages.

⁷⁴ Information obtained through the Ministry of Fuel and Energy of Georgia. November 20, 2003.

Georgian Electricity Sector: 1992-2001

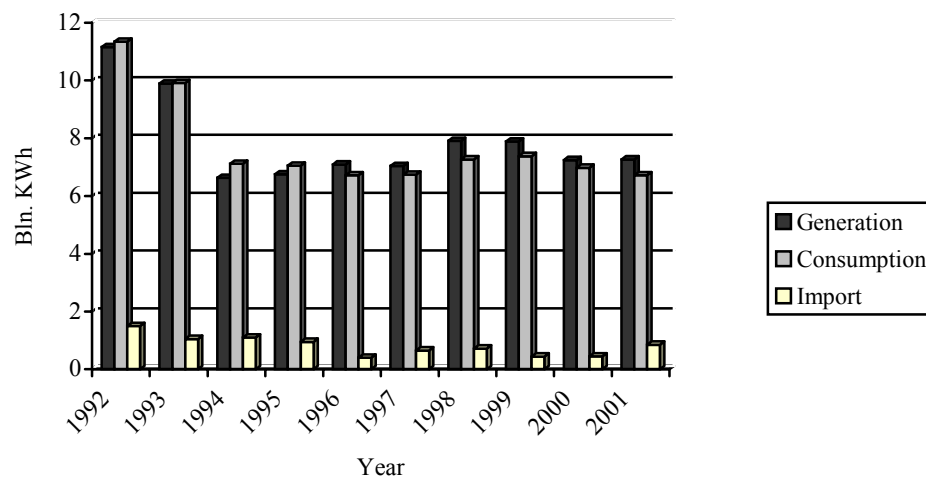


Figure 1. Georgian Electricity Sector, 1992-2001

(Source: US Energy Information Administration, 2003 Data. Available online at: <http://www.eia.doe.gov/emeu/international/electric.html#IntlTrade>. Accessed June 3, 2004.)

The only solution to the existing severe problem in the electricity sector was to invite foreign investment for capital investments and development of infrastructure modernization programs. Therefore in May 1998 the Government of Georgia, through Merrill Lynch as its privatization adviser, released a Descriptive Memorandum for the privatization of ‘Telasi’, the largest of five electricity distribution companies serving the capital Tbilisi. Two companies submitted bids and after two months of negotiations, the Georgian Government and the AES Corporation, a US-based power generating and distributing enterprise, reached an agreement. In this transaction, seventy five percent of the shares of ‘Telasi’ were transferred to AES. Another twenty five percent of the shares remained in the possession of the Georgian state.⁷⁵ AES also became the owner of ‘Transenergy’, the company set up for delivering electricity from Russia to Turkey; two power-generating units of the Tbilisi power plant (with total capacity of 600 megawatts);

⁷⁵ See the website of the Ministry of Fuel and Energy of Georgia: http://www.minenergy.ge/energo_site/distribution.htm. Accessed January 16, 2004.

and two hydroelectric power plants (over 200 megawatts) for the next twenty-five years. As a result the U.S. Corporation gained control over thirty percent of power generation and sixty percent of distribution in Georgia.

According to the sale and purchase agreement between the AES and the Georgian Government, the parties agreed not to transfer any shares or assets obtained through the deal to any third party during the period of five years. “[A]t any time after five years after the Agreement Date [December 21, 1998] AES may transfer, assign or novate the Shares and this Agreement . . . to a third party with the prior consent of the State . . .”⁷⁶

On August 1, 2003, referring to a press release from AES, Russian media reported that the “AES Silk Road, a subsidiary of U.S.-based AES, has agreed to sell its electricity generation and distribution companies in Georgia to RAO Nordic Oy, part of the Unified Energy System of Russia group.”⁷⁷ The same source indicated that according to Mr. John Huffaker, the president of AES Silk Road, the parties had by that time already drafted the purchase contract, which was to take effect starting from September 2003. In this way, the Russian Joint Stock Company ‘Unified Energy Systems of Russia’ (hereafter ‘RAO UESR’) obtained a considerable share of the Georgian energy market.

Purchase of Georgian energy assets by Russian electricity giant indicates growing significance of Russian influence in the region. Following chapter of this thesis assesses Russian electricity sector and analyzes its role in Russian domestic and foreign policies.

⁷⁶ Ministry of Fuel and Energy of Georgia, “Agreement for the Sale and Purchase of Seventy Five Percent (75%) of All of the Shares in Joint Stock Company Telasi.” Article 17.1.2.

⁷⁷ “AES To Sell Business in Georgia to UES,” *Interfax News Agency*. Moscow, August 8, 2003. Online. Accessed through <<http://www.nexis.com/research>>. June 3, 2004.

IV. ASSESSMENT OF THE RUSSIAN ELECTRICITY SECTOR

A. OVERVIEW

At present, two main enterprises produce, transmit, and dispatch nearly one hundred percent of Russian electricity. One of them is Rosenergoatom, the company in the possession of the Ministry of Atomic Energy, which accounts for nearly 16 percent of the country's total annual electricity production of 815 billion kilowatt-hours [KWh].⁷⁸ The remaining 84 percent of power production is unevenly distributed among 73 regional energy companies (for domestic consumption) and the joint stock company Unified Energy System of Russia (RAO UESR.) The latter consists of more than 700 power plants with total output of 200 Giga-watts and nearly 2.5 million kilometers of power grids of all classes. Nearly 90 percent of these assets are concentrated in the Unified Energy Systems of the Russian Federation, under the administrative control of the RAO UESR.⁷⁹

The Unified Energy Systems of the Russian Federation is a unique structure that encompasses all stages of the electricity sector. These stages include the electricity production enterprises (generation), electricity transmission services (power grids), operational dispatch control units, and final delivery of the electricity to individual consumers. Since the creation of the RAO UESR, together with the state it became co-owner and the manager of all the assets incorporated to the Unified Energy Systems of the Russian Federation. The RAO UESR is a main successor of the Unified Energy Systems (UES) of the Soviet Union, which before the dissolution consisted of 11 sub-system networks and covered all 15 Soviet Republics. Namely, the UES of the USSR comprised the following sub-systems: North-West; Central; South; North Caucasus; Trans-Caucasus; Middle Volga Region; Urals; Kazakhstan; Central Asia; Siberia; and the Far East. The UES of Trans-Caucasus encompassed the networks of the three Caucasus

⁷⁸ Mark Kramer, "Restructuring of the Russian Electricity Industry." Center for Strategic and International Studies. PONARS, Policy Memo #304. November 2003. Online. Available at: <http://csis.org/ruseura/ponars/policymemos/pm_0304.pdf>. Accessed January 20, 2004.

⁷⁹ V. A. Barinov, V. V. Bushuev, E. P. Volkov eds., "Energy Security: Problems of Functioning and Development of the Electricity Sector," in *Russian Security: Legal, Socio-Economic and Scientific/Technical Aspects*. Moscow: MGF Znanie, 2001. p.8. [Translated by author].

republics – Georgia, Armenia, and Azerbaijan. After the collapse of the Soviet Union and the formation of the Commonwealth of Independent States (CIS), in 1991-1992 the Unified Energy Systems of the USSR disintegrated into several independent entities within the borders of the newly formed sovereign states. As a result, network links that earlier functionally constituted the single entity acquired the inter-state status. This change affected the network between the UES of Russia and the energy systems of the Baltic States (North-West); Belarus; Ukraine (Central); Kazakhstan (Kazakhstan); and the Caucasus (Trans-Caucasus). Consequently, the link between Russian energy resources and the markets of Central and Eastern European states became possible only through the power grids of Ukraine, Moldova, and Belarus. The link between the UES of the Russian Federation and the energy markets of the Middle Eastern countries (Turkey, Iran) could be established only through the energy systems of the Caucasus and the former Central Asian republics of the Soviet Union. During the Soviet era, the UES of the USSR extensively exported the electricity to several (mainly satellite) states of Eastern Europe (Bulgaria, Hungary, Poland, former GDR, Romania, and former Czechoslovakia). Additionally, Russian electricity was supplied to Finland, Norway, and Mongolia. Relatively small quantities of the electricity were exported to several regions of Western Europe. After the disintegration, foreign energy markets were separated from Russia by the belt of independent states, the so-called ‘Near Abroad.’

Following the collapse of the Soviet economy and disintegration of the Unified Energy Systems network of the USSR, at the beginning of 1990s, the Russian electricity sector faced two fundamental tasks: to rebuild the Russian energy sector, adopting it to the realities of market economy, and to reestablish the unified network of energy systems of all post-Soviet republics. The second task became essential because it would guarantee the successful export of Russian electricity. In December 1992 the State Committee of State Property Management of the Russian Federation issued an order on the establishment of Russian Joint Stock Company ‘Unified Energy Systems of Russia’ (Directive #1013-p, December 3, 1992). The order was based on two presidential decrees, one authorizing the creation of RAO UESR, where the state should own at least 49

percent of the shares of the company or its subsidiaries.⁸⁰ The Decree affected nearly 500 different organizations and industrial enterprises that in one form (direct enrollment into the newly created RAO UESR), or another (subsidiary enterprise of RAO UESR) became the property of RAO UESR. In addition, the company acquired the main power grids and substations of the Unified Energy Systems of Russia. A complete list of enterprises as well as power grids and substations is available in Russian as Annexes 1&2 to the Presidential Decree #923. Another decree (#1334, adopted November 5, 1992) specified several terms and conditions for RAO 'UES of Russia', its subsidiaries, and the management, among which Article 3 particularly stated that the Chief Executive Officer (CEO) of the Board of Directors ought to be appointed by, and act on behalf of, the Government of the Russian Federation during meetings with shareholders.

B. PERCEPTION OF THE RUSSIAN LEADERSHIP REGARDING THE ELECTRICITY SECTOR IN RUSSIA

The current Russian political leadership faces a two-fold challenge with regards to the electricity sector. On one hand, the presidential administration fully acknowledges the importance of the sector in achieving its political aspirations and therefore makes tremendous efforts to maintain control over the electricity sector. On the other hand, in the long run liberalization of the electricity sector turns out to be an inevitable outcome, as the process itself offers huge political and economic benefits to the state. These statements apply both to foreign and domestic issues. Internationally, electricity as a source of Russian comparative advantage on the international market has a high priority in foreign policy, the central goal of which, as former Russian Foreign Minister Igor Ivanov has put: "[w]as and remains creating the optimal external conditions for continued domestic transformation that strengthens the government, improves the economy, and increases the well-being of Russian citizens."⁸¹ Maintenance of state control over the electricity sector facilitates the creation of favorable external political (and to a lesser extent, economic) conditions for implementing Russian interests.

⁸⁰ Presidential Decree: "On the Management of the Electric Power Complex of the Russian Federation under privatisation." No. 923, August 15, 1992. Article 1. Available on the Website of RAO 'UES of Russia', at: <http://www.rao-ees.ru/ru/rights/law/show.cgi?uk_923.htm> Accessed January 19, 2004. [Translated by Author].

⁸¹ Igor Ivanov, *The New Russian Diplomacy*, Washington DC: Brookings Institute, 2002. p. 141.

However, the deregulation of the industry, and thus loosening of state control, seems likely in the long run, as the Russian Federation seeks closer interaction with several international institutions. More concretely, Russia's candidacy for membership in the World Trade Organization (WTO), for example, has been continuously suspended partly because of the absence of sufficient liberalization reforms in the energy industry (especially gas and electricity). Notably, among those who actively question Russian membership in the WTO is the European Union (EU), the largest importer of Russian energy products.⁸² One of the major claims that have been made under the framework of deregulating the energy industry is that Russia has to boost the tariffs on gas and electricity domestically. The Agence France Presse quoted Russian Deputy Minister of Economy, Trade and Development, Mr. Maxim Medvedkov, as stating: "[o]ne of the main stumbling blocks remained the WTO's insistence that Russia end its subsidies for local energy consumers and introduce electricity tariffs that correspond to European prices . . . [t]his is not a standard requirement. We cannot commit ourselves to this."⁸³ A similar pattern appears in relations between the Russian Federation and the IMF. Interfax News Agency, for example, recently reported that the IMF "has recommended Russia raise its energy resource prices to international levels, because subsidizing distorts the economic picture."⁸⁴ Normally the state subsidizes tariff payments by individual consumers and various organizations (factories, hospitals, educational institutions etc.) to RAO UESR. Most of the time subsidies are not coming through directly into the RAO UESR from the federal or regional budgets. Instead, non-payment is widely accepted practice and because of the strong state influence and direct co-ownership of the RAO UESR, the company management is not able to extract the tariffs from Russian government. As a result the RAO UESR loses considerable amounts of financial income.

⁸² For closer look at Russian interests in cooperation with the EU, in the WTO membership, as well as obstacles that the leadership faces in terms of the membership, see: Randall Stone, "Russia and Multilateral Institutions." Center of Strategic and International Studies, PONARS Policy Memo No. 271. October 2002. Online. Available at: <http://www.csis.org/ruseura/ponars/policymemos/pm_0271.pdf>; "Russia and the World Trade Organization," PONARS Policy Memo No. 233, January 25, 2002. Online. Available at: <http://www.csis.org/ruseura/ponars/policymemos/pm_0233.pdf>. Accessed February 8, 2004. For more detailed analysis on the subject see: Harry Broadman, "Global Economic Integration: Prospects for WTO Accession and Continued Russian Reforms," *The Washington Quarterly*, 27:2 Spring 2004. pp. 79-98.

⁸³ "Russia may not join WTO until 2007: minister." *The Agence France Presse*, Moscow, August 16, 2002. Online. Accessed through: <<http://www.nexis.com/research>>. February 15, 2004.

⁸⁴ "IMF Asks Russia To Up Energy Resource Prices." *Interfax News Agency*, Moscow, February 11, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. February 17, 2004.

Complete deregulation of the electricity sector would lead to the emergence of private, non-state enterprises whose goals might contradict those of the political leadership. If at present the state manages to hold onto the policies of cross-subsidization, in a private business environment this type of interference will become extremely difficult. State subsidies, as well as tariff control policies, will be eliminated. But the risk of losing the dominance over the energy industry is largely balanced by forthcoming benefits (political/economic) that the WTO membership will bring to Russia. Therefore the Putin Administration seems ready to compromise on the demands to liberalize. As a result, the government has launched a long-term, large-scale reform project of the electricity sector (a more detailed analysis of the reform will follow).

While the reform plan is progressive in its essence, it is limited in several ways: the reform is stretched over a considerable period of time; and deregulation of tariffs on electricity is considerably delayed. Both points are closely inter-connected and represent domestic issues that concern the current presidential administration. Liberalization of the industry leads to an inevitable rise of tariffs on electricity for individual consumers. While this is the requirement of the international community, immediate increases in the price of electricity will seriously damage the prestige of the administration and may cause social unrest in the country. On the eve of presidential elections in March 2004, President Putin certainly worried about the opinion of the Russian electorate. The concerns over international and domestic issues motivated President Putin to make the following claim during the meeting with business representatives of the Russian Federation and Germany:

I would remind you that one of the main obstacles at the moment in completing the discussion process with the European Union is energy issues . . . I assure you, if we drastically move to world prices on energy resources, the macroeconomic stability will be disrupted . . . We cannot move to international prices on energy resources within the country in a single day. This is impossible. We would cause the entire Russian economy to collapse. This is impossible by definition . . . We intend to do this in stages, first of all. And secondly, taking a flexible position, we are prepared to hold talks, but not within the framework of Russia joining the WTO, but rather within the energy bloc of the EU . . . We consider it

incorrect and illogical to hold dialogue on energy within the framework of joining the WTO.⁸⁵

One of the ways that the Russian leadership chose to deal with the existing challenge is by developing relevant legislation. The process of improving the legislation has been underway for almost a decade now, so that currently the state sufficiently maintains its interests in the electricity sector through laws, governmental decrees, and other relevant documentation. Given that capabilities to enforce these laws are fairly adequate, the presidential administration should be able to effectively constrain current or future business actors (private as well as state enterprises, if any) from diverging in their interests apart from those of the state. There are numerous legislative acts concerning the electricity sector, but several of them deserve special emphasis. In particular, these include: 1) Federal Law of the Russian Federation on State Regulation of Tariffs for Electric and Thermal Power (No. 41-FZ. Adopted March 1995. Last amended July 2003); 2) Federal Law of the Russian Federation On Natural Monopolies (No. 147-FZ. Adopted: July 1995. Last amended March 2003); 3) Federal Law of the Russian Federation On Electric Power Industry (No. 35-FZ. Adopted March 2003); and 4) Decree of the Government of the Russian Federation On Restructuring the Electric Power Industry (No. 526. Approved July 2001).⁸⁶ The following section examines these laws in more detail.

1. Federal Law On State Regulation of Tariffs For Electric and Thermal Power

The law is important in several ways: It defines that the state retains authority in regulating tariffs on the electricity for the wholesale market, as well as individual consumers. The purpose of the state regulation of tariffs (article 3) is to protect economic interests of consumers against uncontrolled increase of tariffs, so it sets limitations on existing natural monopolies (RAO UESR) in the electricity sector. Additionally, the law defines relationships between the central government and the regions in terms of

⁸⁵ Press-Centre of the President of the Russian Federation, President Vladimir Putin. Speech. "Speech at a meeting with representatives of business circles of Russia and Germany." October 9, 2003. Online. Available at: <http://www.kremlin.ru/eng/text/speeches/2003/10/091610_53797.shtml>. Accessed February 8, 2004.

⁸⁶ These, as well as other relevant legislative acts are available on the website of the RAO UESR, at: <<http://www.rao-ees.ru/en/reform/>>. Accessed February 10, 2004.

establishing tariffs on electricity. The Federal government retains authority to cancel any decision of a regional executive body concerning an increase in prices.

2. Federal Law On Natural Monopolies

The law formally is entitled to protect the rights of the citizens and create a competitive business environment within the Russian Federation. It aims to achieve the balance of interests between the state and the economic elite, which even under the supervision of the state possesses natural monopolies. In the electricity sector, spheres that acquire the status of natural monopoly include electric power transmission services and operational dispatch control (article IV). The state exercises control over natural monopolies in several ways that include (but are not limited to) price regulation (article VI) and direct supervision of the bodies regulating the activities of natural monopolies by the president (article IX). In addition, whether the transaction is economically justified or not, any given sphere of natural monopoly, including the electricity sector, is obliged by the law to provide relevant services (sell products) to the individual consumers (article VIII).

3. Federal Law on Electric Power Industry

The law is the main document designed to set the legal basis and define economic foundations in the sphere of electricity. It specifies the authority of federal executive power over the producers of the electricity, as well as responsibilities of the latter towards the state. As a primary means to control the producers of electricity, the state uses its right to set tariffs on the product. Towards the end of the transitional period, as shown elsewhere, the state plans to loosen control over the price formation process and to deregulate tariffs on electricity. The law also regulates relationships among the federal government and the constituent entities of the federation, as well as local (regional) governments with regards to exercising power over the electricity sector. Regions of the Federation are restricted in their ability to adopt any piece of legislation concerning the sphere of electricity, which may contradict or bound the laws and regulations of the federal government. According to the law, fundamental principles of state policy with regards to the electricity sector, among other factors, include provision of energy security; balance of economic interests of suppliers and consumers; social protection of Russian citizens against unjustified increase in tariffs on electricity; and retaining

control/ownership in the areas where the conditions for competition are absent or restricted. The last factor refers to transmission of electric power (power grids), including to foreign countries and distribution (operational dispatch) services. These services are currently performed by RAO UESR, but the government plans to regain ownership and organize the enterprises as joint stock companies, where during the restructuring period the state will control no less than 52 percent of the shares, while after the restructuring the overall share of the state should increase up to 75 percent (Article VIII and XII).

4. Decree on Restructuring the Electric Power Industry

The decree is the result of the long-standing debate between the government and the management of RAO UESR. It reflects the process of ongoing reform in the field of electricity production (generation), transmission, and distribution services, as well as the formation of the wholesale and retail electricity markets. Currently, the RAO UESR itself and its subsidiaries conduct all these activities. As a result of restructuring the electricity sector, the private companies will take over the production field, while the state will perform transmission and distribution services. In short, according to the decree, the restructuring process is divided into three broad stages. It mainly covers the RAO UESR and its subsidiaries, as well as small private generating companies within the Russian Federation. Overall, the restructuring process looks as follows: During the first stage (three years), the RAO UESR will dissolve into three separate entities: The federal power grid company; the system operator (operational dispatch center), both initially subsidiaries of the RAO UESR, and eventually the state-owned enterprises; and 10 wholesale generating companies owned by the private sector. The regulation of tariffs on electricity, at the first stage of restructuring, remains under the governmental control. The second stage (two to three years) mainly covers the development of the wholesale markets. By this time private generating companies should be already in place and the state should assume its responsibilities in terms of transmission and distribution services. Notably, this period marks the deregulation of tariffs on electricity. While private generating companies will set prices on their product, the state establishes its price on transmission and dispatch of the electricity. The third and final stage (three to four years) generally intends to create a competitive environment in the field of electricity generation and sales. The main intent is to facilitate inflow of investments and improve existing

infrastructure. Additionally, “the state will stop performing non-relevant functions of administrative manager in competitive sectors of the electric power industry” (Article V).

The following conclusions can be made through the analysis of the presented legislation:

First, preserving the right to regulate tariffs on electricity enables the Russian state to employ this measure as the political tool facilitating its interests vis-à-vis the economic elite in the field. As long as the policy of state control remains in place, the presidential administration will successfully manage to restrain economic players from adopting independent, solely business-oriented policies. The latter’s inability to maintain absolute control over their business interests, in turn, prevents the economic actors from gaining political influence domestically and expanding their interests beyond the borders of the Russian Federation. Also, the state practice of maintaining exclusive rights on the establishment of tariffs on electricity serves an important domestic social goal: it lessens the risk of any social unrest that might emerge as the result of immediate deregulation of the electricity industry and an increase of tariffs on the product for individual consumers.

Second, any advantage that the state currently takes in terms of exercising the right to control tariffs on electricity is temporary. Eventually the Russian electricity sector, according to the existing plan, has to be liberalized. Deregulation of tariffs will considerably diminish the role of the state and ideally the market relationships will determine the tariff range on electricity. But, even so, attempts to liberalize the industry in the long run should not be seen as the state failure to secure its interests with regards to the private economic actors. Through liberalizing the electricity sector the presidential administration makes a major contribution towards completing a key objective of Russian foreign policy: to gain international prestige and achieve the conditions that permit more productive interaction of the Russian Federation with the core international organizations. Primarily, it means “Russia's further integration in the world economy [and] full-fledged participation . . . in international economic organizations.”⁸⁷

⁸⁷ “Foreign Policy Concept of the Russian Federation,” Approved by the President of the Russian Federation, V. Putin, June 28, 2000. Article 3.3. *International Affairs: A Russian Journal*, No. 5, 2000. Online. Available at: <http://www.ciaonet.org/olj/iarj/iarj_00_05a.html>. Accessed June 8, 2004.

Third, through the relevant legislation the state reinstates control over the regional bureaucracies. The central government has the ability to overrule decisions made by the regional governors concerning the increase of tariffs on electricity. The state's ability to declare these decisions invalid is justified by a noncompliance to the federal legislation. By limiting independent decision-making capabilities of the regional authorities, the central government simultaneously reduces the latter's opportunity to collaborate with economic actors and diminishes the possibilities that these actors will gain political control at the regional level within the Russian Federation.

Fourth, the state dismantles monopolies in the fields where competition is possible, but at the same time maintains strict control over the natural monopolies for the sake of its own interest. Natural monopolies are strategically important sectors of the economy that fall under special interest of the state. Adoption of proper legislation allows the state to be in full control of natural monopolies and to prevent private companies from either creating or gaining control over the monopolies. By dismantling the monopoly in the electricity sector and by exercising various means of control over the sector, the state limits power of the economic elite, restrains the latter's ability to perform independently on the international arena, and most importantly, retains the ability to use the sector in the goal of achieving national aspirations with regards to the relationships between the neighboring countries.

Finally, focusing exclusively on the political side of the analysis would not reflect the whole complexity of the situation. The factor of economic efficiency plays an important role as well. The legislation directly reflects the overall trend of the Putin Administration to orient Russia's domestic and, more importantly, foreign policy towards achieving core economic objectives. The Russian legislation in the field of the electricity sector frames those crucial achievements that claim to be beneficial from an economic point of view. These achievements include: the increase of economic efficiency through the liberalization of the electricity industry; the creation of a competitive business environment domestically; and establishment of sufficient conditions for attracting foreign investments in the electricity sector that are crucial for the economy of the Russian Federation.

The domestic challenges that Russia faces in terms of developing the electricity sector are closely interconnected with the international factors shaping Russian foreign energy policies. "The global character of the problems associated with the energy issue, and their dynamically increasing political nature . . . converted it into an essential element of Russian diplomacy."⁸⁸ Main priorities of Russian foreign policy with regards to the electricity sector include an integration of the state into the world's energy systems that must be implemented by exploring new energy markets and strengthening Russia's role in them. The policies that the state pursues internationally are directed towards facilitating maximum political gains from business interactions while exporting or transiting electricity to foreign markets, facilitating international projects that might attract foreign capital investments to Russia, and acquiring capital assets of the energy sectors in neighboring states. Additionally, the current presidential administration puts enormous efforts into "expanding the geographical presence of Russian companies on the international market"⁸⁹ through facilitating their participation in large-scale international export projects. Russia's Minister for Industry and Energy, Viktor Khristenko, according to the Financial Times, described the Russia-driven integration of energy systems in the former Soviet states as "an instrument of solving political issues in the CIS."⁹⁰

As a point of departure for achieving these goals, the Russian leadership has to ensure the creation of a proper political climate in the immediate neighboring environment. Therefore, at the initial stage, gaining control over the energy markets of the Commonwealth of Independent States, including Georgia's energy sector, becomes vitally important. Successful implementation of this initial stage of Russian foreign policy will ensure further expansion of geopolitical interests towards the West, East and South.

C. ECONOMIC ELITE REGARDING RUSSIA'S ELECTRICITY SECTOR: THE ROLE OF RAO UESR IN INTEGRATING THE POST SOVIET SPACE

⁸⁸ Ministry of Industry and Energy of the Russian Federation, "Energy Strategy of Russia up to 2020." Adopted August 28, 2003, No. 1234-R. p. 42. Online. Available at: <<http://www.mte.gov.ru/files/103/1354.strategy.pdf>>. Accessed April 29, 2004. [Translated by author].

⁸⁹ "Energy Strategy of Russia up to 2020," pp. 41-42. [Translated by author].

⁹⁰ Vladimir Radyuhin, "Russia's Economic Diplomacy." *Financial Times Information, Global News Wire - Asia Africa Intelligence Wire*. April 27, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 24, 2004.

Russia is the fourth-largest producer of the electricity after the USA, China, and Japan. It generates 5.4 percent of the world's electricity and the production capabilities continuously grow. Seventy percent of generated electricity in Russia belongs to the RAO UESR, which holds the first place among the world's ten largest electricity companies and employs 632,000 workers.⁹¹ Together with Gazprom it is the largest monopoly in energy supplies. RAO UESR is the industrial holding that consists of a number of regional subsidiary companies, federal hydro/thermal power plants and power grids. The RAO UESR has brought under control four-fifths of Armenia's hydroelectric power capacities and bought up most of Georgia's energy facilities. The UES has acquired stakes in electricity assets in Kazakhstan, is about to buy major stakes in 10 of the 27 Ukrainian energy companies, and plans to participate in the disinvestment of power assets in Moldova. In Kyrgyzstan, UES has set up a joint venture with two local companies to build a cascade of two hydropower stations.⁹² In addition, recently the Russian media reported that during the meeting between the RAO UESR CEO Anatoly Chubais and Azeri President Ilkham Aliyev, in late May 2004, they signed a memorandum "On the Cooperation in the Energy Sector." According to the press, the cooperation includes development of an electric power grid network, for possible future exports of electricity to Iran and Russian investments in Azeri power sector.⁹³

Throughout the long debates among several Russian governmental organizations and agencies on how to handle the complicated issue of the electricity sector at the end of the 1990s, eventually an understanding was reached on the necessary structural changes, which in practice essentially had to separate natural monopolies (transportation and dispatch) and competitive spheres (production and final distribution) of the electricity sector, as well as introduce the principles of the market economy. The group that actively

⁹¹ Source: "RAO UES of Russia: Energy of Reforms." Presentation by the Chairman of the Board of Directors of RAO UESR, A. B. Chubais. 7th Economic Forum on Russia. London. April 19, 2004. Online. Available at: <http://www.rao-ees.ru/ru/info/management/abc/show.cgi?190404_chu.htm>. Accessed May 16, 2004. [Translated by author].

⁹² Vladimir Radyuhin, "Russia's Economic Diplomacy." *Financial Times Information, Global News Wire - Asia Africa Intelligence Wire*. April 27, 2004. Accessed through: <<http://www.nexis.com/research>>. May 24, 2004.

⁹³ "Russia And Azerbaijan Reached An Agreement On Cooperation," *Interfax News Agency*. May 24, 2004. Online. Available at: <http://www.interfax.ru/r/B/0/0.html?id_issue=9703608>. Accessed May 25, 2004. [Translated by author].

lobbied for the idea of reforming the RAO UESR, and thus the whole electricity sector of Russia since 1998, is associated with one of the most contentious figures of Russian politics, the CEO of RAO UESR, Mr. Anatoly Chubais. Chubais and his team are the initiators of ongoing reforms of the electricity sector, which instigated extensive debates and became the subject of speculations both domestically among Russian politicians and abroad.

In general, the company's management prioritizes the political goal of economic growth of the Russian Federation. The reform and liberalization of the energy industry is tied to Russia's overall existence: "the future of Russian electricity sector determines the destiny of the state and represents the key factor for the overall existence of . . . the state."⁹⁴ At the same time, the company has vested business-oriented interests in the reformation of the electricity sector. Primarily, these interests include the formation of a competitive business environment in Russia; the creation of favorable conditions for foreign investments in the electricity sector; and the promotion of the principles of the market economy. Accordingly, "[t]he idea of reforming the Russian electricity sector has evolved directly from the answer to very simple and evident questions: who pays, how much, to whom and what is to be paid."⁹⁵ These interests, from the company's point of view, serve the goal of gaining economic profit.

Even though the state and the management of the RAO UESR agree on a number of core developments both domestically and in terms of the export priorities, controversies on the issues of the state's role in regulating the electricity sector, the degree of control that the federal government is able to maintain over the industry, and the basic timelines of reforming the electricity sector still exist. The strategy of enforced state participation in the management functions of large businesses has several policy implications. It caused the emergence of governmental policies securing shares of strategically vital enterprises under the federal control. Governmental strategy also introduces severe state control over the natural monopolies and it centralizes

⁹⁴ RAO Unified Energy System of Russia, *80 Years of Developing the Energy Sector: From the GOELRO Plan to Restructuring the RAO UES of Russia*. Moscow: AO Informenergo, 2000. p. 443. [Translated by author].

⁹⁵ RAO UES of Russia, "Reforming the Russian Electricity Sector." Online. Available at: <<http://www.rao-ees.ru/en/reform/show.cgi?reform.htm>>. Accessed April 25, 2004.

administrative management responsibilities, normally affiliated with the regional authorities. Therefore, RAO UESR's main criticism is directed towards the state's excessive control over business. Controversially, on the one hand the RAO UESR is a joint stock company and it should be managed according to economically beneficial corporate interests. On the other hand, the state directly regulates the industry through having the right to set the prices and tariffs on products and services. Additionally, "the state protects its interests . . . through [co-ownership] in Charter Capital assets of the electricity sector and by securing as federal property a controlling package of the shares of the RAO UESR."⁹⁶

The result of excessive state intervention in the electricity sector is that "through the tariff regulation process political, rather than economically valid, approaches prevail."⁹⁷ Therefore, according to the company's view, the price formation mechanism should be adjusted to reflect the principles of the market economy. Among the required steps in this direction, the state has to eliminate subsidies for the consumers; the tariff structure should reflect the true value of generation, transmission, and distribution services. Additional measures should include decentralization of the government control functions. Regional electricity commissions should have more rights to regulate the tariffs on the local level. All of these factors reflect the argument that the current legislation in the field of the electricity sector lacks sufficient development. The state 'responsibilities' with regards to the economic actors are not well defined, which means that an existing gap in the legislation provides flexibility for the political factors to intervene into economic interactions.⁹⁸

Active government intervention into the electricity sector has several negative effects. One effect is that according to the federal law, in cases where the state is a shareholder possessing more than 25 percent of the shares, every effort of restructuring

⁹⁶ RAO Unified Energy System of Russia, *80 Years of Developing the Energy Sector*. p. 503. [Translated by author].

⁹⁷ Ibid., p. 503. [Translated by author].

⁹⁸ For more detailed analysis of the subject, see: RAO Unified Energy System of Russia, *80 Years of Developing the Energy Sector*. p. 503.

and reforming the joint stock company is subject to approval by the federal law.⁹⁹ This legal practice, according to the management of the RAO UESR, is extremely inefficient and time consuming. First of all, it requires that each initiative, in order to make structural changes or to adopt any procedure that might benefit the business interests of the company, requires the adoption of separate federal law. In the situation where the time factor plays an important role in reaching a particular decision concerning the company's interest, the procedure of passing the law through federal legislative bodies becomes a huge challenge for the company management and requires lobbying, as well as possible compromises of the business interests both to the executive and legislative powers.¹⁰⁰

Another drawback of the existing legislation is that it challenges participation of foreign investors by limiting their ability to become the company shareholders to 25 percent.¹⁰¹ Besides the fact that this restriction limits direct participation of the foreign capital in the electricity sector, it also discourages future possible foreign investors from making investments into the sector. Currently the electricity sector of the Russian Federation is in desperate need for investments. Official estimations vary between 120 – 170 billion USD for the next twenty years. The bulk of these investments are intended for the construction works and modernization of the power generation facilities.¹⁰² In present circumstances, it is difficult to attract domestic investors in the Russian Federation who will have to purchase the company shares according to the market value, but because of the state policies, the chance to attract foreign investors is even less. The company management claims that the state intervention into the investment policies “resulted in considerable decrease in the value of the company shares on the stock market

⁹⁹ Federal Law of the Russian Federation “On the Joint Stock Companies.” Adopted December 26, 1995. No 208 – F3. Article 15. [Translated by author].

¹⁰⁰ For more detailed analysis see: RAO United Energy Systems of Russia, *80 Years of Developing the Energy Sector* p. 508.

¹⁰¹ Federal Law of the Russian Federation “On Specific Features of Handling the Shares of Russian Joint Stock Company of Energy and Electrification ‘Unified Energy System of Russia’ And the Shares of Other Joint Stock Companies of Electrification Under the Federal Property.” Adopted April 1998. No 74-F3. Article 3. [Translated by author].

¹⁰² “Energy Strategy of Russia up to 2020,” p. 67. [Translated by author].

and created a negative image of the shares of all Russian enterprises in foreign stock exchange markets.”¹⁰³

One other issue that until recently was the subject of the debate between the state and the company’s management is the reform schedule. Anatoly Chubais, the company’s CEO, and his entourage is interested in timely completion of the reform process. Evidently, the sooner the competitive sector of the electric power industry will be freed from the government control and will adjust to the principles of the market economy, the more private investments will flow into the industry. Therefore, timeline for the reforms proposed by the RAO UESR is roughly twice as short, relative to the schedule legalized by the Russian government. While the reform principles and the stages remain similar to the ones approved by the state, instead of ten years, initially the management of the RAO UESR suggested completing the restructuring process in four to five years.¹⁰⁴

As a result of controversies between the state and the economic elite, it is a current trend in contemporary Russia that key businesses drift apart from domestic politics and the state is taking over the control. Kremlin, as some argue, over the last few years created “no-go zones between business and politics.”¹⁰⁵ The CEO of RAO UESR is a clear example of this trend. Anatoly Chubais is the initiator of Russia’s economic reforms including the privatization process in early 1990s. Since 2001, together with Boris Nemtsov, he was the co-chairman of the Union of Right Forces (URF - *Soyuz Pravykh Sil*), a liberal, pro-market-oriented political party that experienced a total fiasco during 2003 parliamentary elections in Russia. Even though the party initially launched quite an ambitious election campaign,¹⁰⁶ it did not pass the five percent election barrier

¹⁰³ RAO Unified Energy System of Russia, *80 Years of Developing the Energy Sector*. p. 510. [Translated by author].

¹⁰⁴ For the position of the Russian government see in previous section of the chapter: the “Decree on Restructuring of Electric Power Industry;” For the summarized analysis of the proposals made by the company management see: “Concept of RAO UESR’s Strategy for 2003-2008: The 5+5.” Article 6.1. Moscow, 2003. Online. Available on the website of the RAO UESR at: <<http://www.rao-ees.ru/en/show.cgi?info/con2003.htm>>. Accessed May 16, 2004.

¹⁰⁵ Nikolas K. Gvosdev, “The Sources of Russian Conduct.” *The National Interest*, Spring 2004; 75. p. 32.

¹⁰⁶ Details of the election campaign are available on the official website of the Union of Russian Forces at: <<http://www.sps.ru/>>. Accessed May 24, 2004.

required to win seats.¹⁰⁷ As a result, the URF was left without seats in the new Russian parliament and Anatoly Chubais resigned from the position of party co-chairman in January 24, 2004.¹⁰⁸ Polls published by the Russian Center for Public Opinion Studies (VCIOM) indicate his low popularity among the Russian population. At 29 percent, Anatoly Chubais was named ‘anti-hero’ of 2003.¹⁰⁹

If domestic politics increase the number of disagreements between the state and key economic actors, in the field of international cooperation there is more commonality of interests. The RAO UESR expansion of its business beyond the Russian borders remains one of its key priorities. With strong state support the company management magnifies its participation in the international energy markets through the efforts to reunify the energy systems of the post-Soviet space and to implement long-term cooperation projects with members of the CIS. Bearing in mind its potential for increased electricity generation, the RAO UESR management seeks export markets. Projected maximum possible quantities for export dramatically mount from almost 50 billion kilowatt hours (kWh) in 2005, up to 162.47 billion KWh by 2020.¹¹⁰ On the large scale, the company intends to work virtually in every possible direction, including:

- North-Western – Finland, Norway, Swiss, Lithuania, Latvia, Estonia;
- Western/South-Western – Byelorussia, Ukraine, Moldova, Poland, Germany, Slovakia, Check Republic, Austria, Hungary, Romania, Bulgaria, Greece, Former Yugoslavia;
- Southern – Georgia, Azerbaijan, Armenia, Turkey, Iran;
- South-Eastern – Kazakhstan and Central Asian countries;
- Eastern – China, South Korea, North Korea, Japan.¹¹¹

¹⁰⁷ Detailed data is available on the website of Levada Center, one of the major trusted public opinion research centers in the Russian Federation, at: <<http://www.russiavotes.org/>>. Accessed May 24, 2004.

¹⁰⁸ Personal website of Anatoly Chubais, “Anatoly Borisovich Chubais, Biography.” Online. Available at: <<http://www.chubais.ru/personal/biography/show.cgi?biogr.htm>>. Accessed May 24, 2004. [Translated by author].

¹⁰⁹ “Politician of the Year and Anti-Hero of Russia according to Russians.” Center for Public Opinion Studies (VCIOM). Press Release No. 46. December 23, 2003. Online. Available at: <<http://www.vciom.ru/?pt=42&article=42>>. Accessed May 24, 2004. [Translated by author].

¹¹⁰ RAO Unified Energy System of Russia, *80 Years of Developing the Energy Sector*. p. 388. [Translated by author].

¹¹¹ Ibid., p.389.

One of the important dimensions of Russian economic expansion in the field of the electricity export, as shown, is the Southern route that together with the Caucasus countries includes Turkey and Iran. During the last decade, Turkey experienced relatively stable economic growth and “as its economy expands, Turkey expects a very large growth in energy demand, especially for electricity and gas.”¹¹² Part of the Turkish demands for the electricity, according to the view of the RAO UESR, may be satisfied through electricity imports from Russia. Currently the agreement for electricity supply to Turkey from Russia has expired. In 2001-2002 the electricity exported from Russia to Turkey ranged between 180.49 and 92.76 million kWh respectively.¹¹³ Negotiations are now underway to conclude a new agreement providing for an increase in the electricity supplies, but there has been no decision reached yet. Russia exports electricity to Turkey, and may continue to do so, mainly via two routes. One existing practice is the transit of the electricity through Georgian high voltage power grid (mainly through the breakaway Autonomous Republic of Abkhazia). The problem with the existing inter-state transmission network is that it does not allow enough energy transit to satisfy the Turkish demand. Therefore the RAO UESR management envisages the possibility to enhance this route by acquiring the right to develop the necessary transmission infrastructure on the Georgian territory. The cost of this enhancement, according to the company estimations, totals up to 400-550 million USD and may take five to ten years for implementation. Another route that has been discussed is through the Black Sea, as an underwater electricity power cable, going in parallel to the existing “Blue Stream” gas pipeline between the Russian Federation and Turkey.¹¹⁴ In terms of Russia’s relationships with Iran, currently neither the RAO UESR, nor any other power-generating company, exports electricity. The main interaction between the Russian Federation and Iran is in the field of the nuclear power industry. The Ministry of Atomic Energy of Russia holds a project for the construction of the nuclear power plant in Busher. This project is estimated to bring

¹¹² The US Department of Energy, “An Energy Overview of the Republic of Turkey.” Last Updated October 20, 2003. Online. Available at: <<http://www.fe.doe.gov/international/turkover.html>>. Accessed April 27, 2004.

¹¹³ RAO Unified Energy System of Russia, “Annual Report: 2002.” Online. Available at: <<http://www.rao-ees.ru/en/business/report2002/>>. Accessed April 27, 2004.

¹¹⁴ For further description see: RAO Unified Energy System of Russia, *80 Years of Developing the Energy Sector*. pp. 421-422.

financial benefit to the Minatom, worth 800 million USD. The existing agreement also includes the construction of five additional nuclear power plants over the next ten years.¹¹⁵

As it was already noted, the management of RAO UESR places special emphasis on the relations with the CIS countries because of its need to expand the business abroad (See figure 1). Among the goals that the company envisages is not only the lobbying of the electricity export projects through the Russian government and reaching appropriate international agreements on the export of the product, but they also aggressively promote the priority of gaining control over the local generation/distribution companies in the CIS. This will enable the RAO UESR management to better organize its business with regards to the international exports. Therefore, after reaching the agreement with the Georgian government in August 2003, and acquiring considerable share of the Georgian electricity sector (30% generation, 60% distribution) the management of RAO UESR obtained larger capabilities to realize the business interests with regards to Turkey and the entire Southern dimension.

¹¹⁵ For further details on the subject see: Celeste A. Wallander, "Russia's Interest in Trading with 'Axis of Evil'." Center for Strategic and International Studies, PONARS Policy Memo No. 248. October 2002. Online. Available at: <http://csis.org/ruseura/ponars/policymemos/pm_0248.pdf>. Accessed April 28, 2004.

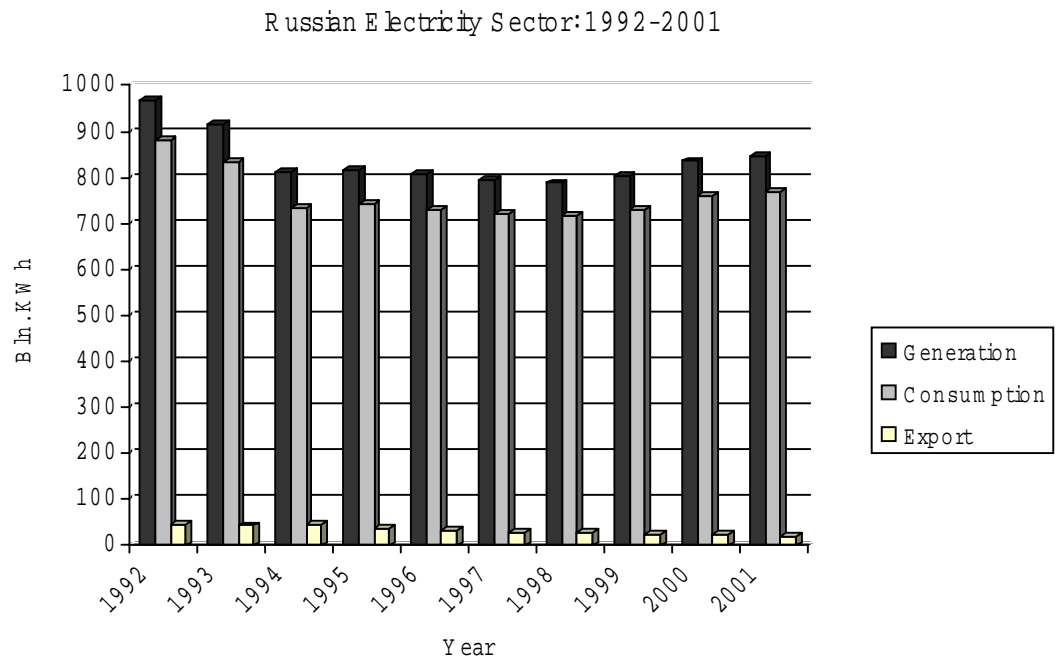


Figure 2. Russian Electricity Sector, 1992-2001

(Source: US Energy Information Administration. 2003 Data. Available online at: <http://www.eia.doe.gov/emeu/international/electric.html#IntlTrade>. Accessed May 24, 2004.)

The controversies between the state and the economic elite on the issues of the foreign policy goals and the export priorities are less evident than in domestic politics. Therefore the argument that the Russian state is using the electricity sector solely for promoting its political aspirations abroad is incomplete. From all the available sources it becomes clear that existing state policy of economic expansion and its claim for the right to acquire regional energy markets is beneficial for both the state and economic players in the Russian Federation. The RAO UESR management feels confident and supports the idea that “it has to be the state, rather than private economic actors, which should maintain the unilateral right to develop export policies for Russian businesses.”¹¹⁶ The major difference is in the cause of existing policy of economic expansion. For the management of the RAO UESR it is primarily the reason of increased business opportunities and therefore the prospect for gaining economic profits. For the state, on

¹¹⁶ RAO Unified Energy System of Russia, *80 Years of Developing the Energy Sector*. p. 498. [Translated by author].

the contrary, the policy of economic expansion through acquiring regional energy markets serves the political goal of regional domination and is a tool for exercising political power abroad. It was this particular understanding of the role of Russia as a whole in the international community and the responsibilities that the state has to assume in order to implement Russia's national interests, both domestically and abroad, that influenced a controversial speech of the RAO UESR CEO Anatoly Chubais, on Russian Liberal Imperialism. In it he argues that Russia:

has to develop and safeguard its leading positions on this [Eurasia] part of the planet during the next fifty years. The Russian ideology . . . has to become the ideology of liberal imperialism, and the overarching goal of the Russian state has to be the construction of a *Liberal Empire* . . . It means that the Russian state has to exploit every possible chance to facilitate the expansion of Russian business beyond state borders.¹¹⁷

Here, state and business interests appear to coincide. These interests are developed more fully in the next chapter with regard to Georgia.

¹¹⁷ Anatoly Chubais, "Mission of Russia in the 21st Century." Personal website of Anatoly Chubais. The Speech given at Saint Petersburg State Institute of Economic Engineering. September 25, 2003. Online. Available at: <<http://www.chubais.ru/personal/first/show.cgi?250903sp.htm>>. Accessed April 28, 2004. [Translated by author, emphasis added].

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V. IMPACT OF RUSSIAN ENERGY POLICY ON GEORGIA'S SOVEREIGNTY

Events that took place in the second half of 2003, more specifically the fact that Russian companies took hold of the Georgian energy market, sparked controversial debates among the Georgian politicians, within the Russian Federation, and internationally. Opinions varied from positive to extremely negative, and we now hear the claim that Russia from now on will use 'banks instead of tanks' to pursue its interests in Georgia. This chapter considers the views of the interested parties and offers policy prescriptions on how to reduce Georgian dependency on Russian energy supplies.

A. RUSSIAN VIEW REGARDING THE SALE OF THE ENERGY SECTOR IN GEORGIA

Russian economic players were first among those who positively assessed the deal between the RAO UESR and the AES, the US-based power generation and distribution company that sold its business to the RAO UESR. From their perspective the deal is solely based on the factors of economic profit. The General Manager of the 'Inter-RAO', subsidiary of the RAO UESR that concentrates its activities on the export of electricity, considers the Georgian market promising because existing tariffs on electricity in Georgia are several times higher than in Russia (2.3 cents for 1 KWh on average for the wholesale market and 6 cents for the Georgian consumers, versus 1.2 cents on average for Russia respectively), and also because the rate of payment in the Georgian capital is high, about 90 percent. According to the RAO UESR forecasts, annual income from electricity sales on the Georgian market will reach 75 million USD, while estimated profit is 10 million USD annually.¹¹⁸ The CEO of RAO UESR Anatoly Chubais reinforces these reasons for the necessity to enter the Georgian energy market with a strategic rationale for the entire Russian electricity sector. In an interview with Vesti.ru, he claimed that in spite of the likely political discomfort caused by the entrance of the Russian company into the Georgian market, the project itself would pay off not only financially, but also in strategic terms. "We have very aggressive plans that

¹¹⁸ "Deal Was Struck with AES Corporation." *Vedomosti*, Moscow. August 7, 2003. [Translated by author].

encompass most of the CIS countries. Georgia is just a first step that already has been made.”¹¹⁹

The response of the Russian government to the entrance of Russian gas and electricity giants into the Georgian market in general was less evident. The media did not particularly depict how officials in the Russian presidential administration or in executive power reacted to ongoing disputes concerning the reasoning behind the actions by the economic elite. Arguably, the export plans either of the Gazprom, or of the RAO UESR, concerning the Georgian market could not be implemented without consent from the Kremlin. Aggressive expansionist policies of Russian energy conglomerates towards the Caucasus follow in line with overall strategic guidelines of the Russian presidential administration regarding the role of energy in Russia’s statehood: “[f]or several decades Russia has been the largest and most reliable supplier of energy resources to the world market . . . and Russia’s role [in the world’s energy market] will be most certainly increasing in the future. At present our companies explore new markets, such as the US, Asian countries and the Far East.”¹²⁰ The previous chapter analyzed the perception of Russian leadership regarding the expansion of Russian energy sector beyond the borders of the state. The document on Russian energy strategy stresses the necessity to convert the energy issue into the realm of diplomacy. The role of the state in the world’s energy markets fundamentally determines its geopolitical influence.¹²¹ Russia’s tremendous energy resources, according to the strategy, are the basis of state’s economic growth and represent the instrument for implementing Russian domestic and foreign policies.

The reason why Russian government officials refrained from actively supporting, or criticizing, the plans of either company becomes obvious against the general background of the relationships between the state and the economic elite in the Russian Federation: despite the diverse interests within the Federation regarding domestic spheres

¹¹⁹ Sergei Brilev, “Anatoly Chubais: We have very aggressive plans.” *Vesti.ru*, Moscow. September 7, 2003. [Translated by author].

¹²⁰ President Vladimir Putin, Speech. “Meeting With the Managers of Russian and Foreign Energy Companies.” June 15, 2003. Press-Centre of the President of the Russian Federation. Online. Available at: <<http://president.kremlin.ru/text/appears/2003/06/47233.shtml>>. Accessed May 18, 2004.

¹²¹ Ministry of Industry and Energy of the Russian Federation, “Energy Strategy of Russia up to 2020.” Adopted August 28, 2003. No. 1234-R. p. 4. Online. Available at: <<http://www.mte.gov.ru/files/103/1354.strategy.pdf>>. Accessed April 29, 2004. [Translated by author].

of influence in the energy sector, there are numerous issues on which the state and the economic elite reached an agreement and found the common solution. Foreign energy policy is one of them. Policies of internationally expanding the energy sector are beneficial both the economic elite and for the state. For the economic elite it is the source of revenue. For the state, in turn, expansion of the energy sector on the post-Soviet space is the tool for exercising political influence. The state took into consideration the broad political response that was triggered through the acquisition of the Georgian energy assets by the Russian companies and in order to avoid further escalation of conflicting opinions regarding Russian energy policies towards Georgia, Russian government refrained from public statements.

B. US CONCERNS OVER THE GEORGIAN ENERGY SECTOR

The US government is a longtime supporter of western energy projects that are underway in the Caucasus region (BTC oil pipeline and BTE gas pipelines). Stephen Mann, adviser to the President George Bush and Secretary of State Colin Powell on Caspian energy policies, repeatedly stressed the US' increased interest in successful and timely implementation of oil and gas transportation pipelines. He argued that the projects would not only "give a much-wanted boost to the Azerbaijani, Georgian and Turkish economy, but also create a conducive environment for regional stability . . . We are interested in seeing Azerbaijani gas on the Turkish market as soon as possible, because this will bring benefit to both Azerbaijan and other project participants."¹²² Reaction to the entrance of the Russian electricity giant into the Georgian market was relatively modest. The US ambassador to Georgia, Richard Miles, expressed dissatisfaction with the fact that electricity assets formerly belonging to the US Company were transferred to the Russian electricity giant.¹²³ In contrast, reaction to the deal between the Georgian government and Gazprom was more negative. The primary concern of the US was the risk that the twenty-five year commitment between Russia and Georgia for gas supply could undermine implementation of BTE gas project. "I hope that the Georgian

¹²² "Us Energy Envoy Backs Baku-Tbilisi-Erzurum Gas Pipeline," *BBC Monitoring International Reports*. September 20, 2002. Online. Accessed through: <<http://www.nexis.com/research>>. May 18, 2004.

¹²³ See for example: "Us Envoy Unhappy With Russian Energy Company Entering Georgian Market," *BBC Monitoring International Reports*. August 7, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 18, 2004.

government will not take any steps, which can prevent the successful functioning of the Baku-Ceyhan and Shah Deniz projects,” the US envoy was quoted as saying.¹²⁴

The US reaction to the access of Russian companies into the Georgian energy market was quite harsh. For the first time since the establishment of diplomatic relations between the newly independent Georgia and the US in 1992, the US administration had to resort to forceful diplomatic measures in order to defend its interests in the region. Thomas Adams, a special US State Department envoy, announced the US administration’s decision to cut financial aid to Georgia by nearly half during his meeting with the former President of Georgia. While US aid to Georgia in 2003 totaled \$100 million, in 2004 the country would receive only about \$60 million. Specifically, Mr. Adams said that a total of \$36 million in funding for two programs in the energy sector was to be eliminated.¹²⁵

C. GEORGIAN RESPONSE REGARDING THE SALE OF THE ENERGY SECTOR

Reaction to increased Russian presence on the Georgian energy market was highly controversial in Georgia. There were a variety of opinions, starting from street demonstrations against the visit of Anatoly Chubais in Tbilisi to conduct negotiations with the former President of Georgia, Eduard Shevardnadze, to positive assessments of the situation promising a reliable supply of energy products and future profit to the Georgian state.¹²⁶ The legislature (primarily opposition parties in the Parliament of Georgia) criticized the deal between the AES and the Russian RAO UESR, but the Georgian government, backed by the former President of Georgia, either refrained from comment, or supported the project. On August 1, 2003, at a special session, Nino Burjanadze, then speaker of the Georgian Parliament stated:

¹²⁴ Andrew Neff, “US Concerned Georgia-Gazprom Co-Operation Will Undermine Caspian Pipeline Projects.” *World Markets Analysis*, World Markets Research Centre. June 9, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 18, 2004.

¹²⁵ Vladimir Novikov and Afanasy Sborov, “Eduard Shevardnadze Suffers For Russia.” *Kommersant*, Moscow, Tbilisi. September 26, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 20, 2004.

¹²⁶ See for example: Denis Pinchuk, “Buy, Russia, Buy.” *Agency for Conflict Situations*. Translated by Howard Goldfinger. Rosbalt News Agency, September 22, 2003. Online. Available at: <<http://www.rosbaltnews.com/2003/09/22/64145.html>>. Accessed May 6, 2004.

[t]he agreement between Georgia and the Russian company [RAO UESR] should be different from the one between Georgia and the US company [AES]. Supplying Tbilisi with electricity and natural gas should not be used for political blackmail . . . Georgia will not be politically independent if it is dependent on another country, especially the northern neighbor, in the energy sphere.¹²⁷

While almost all of the opposition political parties were making the similar statements, the Georgian government expressed a different view. Chairman of the Energy Regulatory Commission of Georgia and former Minister of Fuel and Energy, Davit Mirtskhulava, in an interview with the author, articulated his views concerning Russian policies with regards to Georgia's energy market. According to Mr. Mirtskhulava, Russia's foreign policy is pragmatic in its goals and oriented towards achieving a balance of interests in the post Soviet region. As far as the energy market is concerned, at present the West is less interested in Georgia's developing ties with Russia because of the assumed risk that it might endanger ongoing western energy transport projects (Baku-Tbilisi-Ceyhan (BTC) oil pipeline and Baku-Tbilisi-Erzurum (Shah Deniz) gas pipeline). Such a western approach, according to Mr. Mirtskhulava, is not quite right. Georgia should not depend solely on western energy projects.¹²⁸ The official view was that it is not acceptable to cut ties with Russia simply because Russia is the biggest market for Georgian goods and maintaining close ties is beneficial for Georgia's economic growth. As for the entrance of the Russian electricity and gas giants into the Georgian market, the general trend is leaning towards economic, rather than political reasoning. According to the former minister, the RAO UESR is undergoing substantial structural changes that lead towards eliminating monopolies in Russian energy sector. Therefore the company does not reflect the state policies while conducting the business and it solely targets the tasks of economic nature.¹²⁹

¹²⁷ "Georgian speaker says Russia should not control country's energy system," *The BBC Worldwide Monitoring*. Tbilisi. August 1, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 21, 2004.

¹²⁸ The Agence France Presse quoted Mr. Mirtskhulava saying: "Georgia is interested in having several suppliers, because it guarantees the energy security of the country." See: "US concerned Russian gas deal with Georgia may affect key oil pipelines," *Agence France Presse*. Tbilisi, June 6, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 21, 2004.

¹²⁹ Davit Mirtskhulava, Chairman of the Energy Regulatory Commission of Georgia. Tbilisi, November 20, 2003. Interviewed by author.

The response of non-governmental organizations was critical towards the Russian attempts to get control of the Georgian energy sector. Dr. Vladimer Papava, a senior Fellow at the Georgian Foundation for Strategic and International Studies and the former Minister of Economy of Georgia (1994-2000), commented on the possibility of Russia using Georgian dependency in terms of gas and electricity supplies for political reasons.¹³⁰

In general, according to Dr. Papava, the state controls the economic elite in the Russian Federation. RAO UESR and Gazprom pursue not only economic, but also primarily political interests in Georgia. The essential basis for Russian interests is the expansion towards the south (to Turkey and the Middle East in general). The Georgian energy market itself is small and insignificant for Russia. The fact the Russian companies attempt to take over the Georgian energy market is not an end-state for Russian foreign policy, but rather an intermediate step towards achieving broader political aspirations. According to Dr. Papava, from an economic point of view one might argue that Russia has indirect economic interests in Georgia that facilitate direct economic interests in its southern tier. On the other hand, Russia has direct political interests in Georgia: to preserve control and hold power over the Georgian authorities. If Russia keeps its hand on strategic assets of the Georgian energy market, Georgian authorities sooner or later will have to make significant political concessions for the benefit of the Russian Federation.

According to Dr. Papava, there is a great likelihood that Russia will use Georgian dependency for political gains. The primary gain concerning Georgian sovereignty is the maintenance of a pro-Russian regime in Georgia. There are two basic available Russian strategies to consider: if Tbilisi will not create any political problems, pro-Russian political forces inside Georgia will argue that while the US was in charge of the Georgian energy sector, there was simply no electricity delivered to the individual consumers (Georgia in general and Tbilisi in particular constantly suffers from power outages). However, after Russians take over the market, even if the Georgian side is not able to pay the electricity bill, RAO UESR will supply electricity to Georgia anyway, because this

¹³⁰ Dr. Vladimer Papava, Senior Fellow at the Georgian Foundation for Strategic and International Studies. Tbilisi, November 19, 2003. Interviewed by author.

practice is common for Russian regions as well. According to Dr. Papava, in case this strategy prevails, public opinion will be more sympathetic towards a pro-Russian Georgian foreign policy course. The Russian government, it would be argued, would be kind and supply the electricity despite Georgia's non-payment. This factor creates the likelihood that in the future any new Russian-oriented politician will gain support of the population simply because the public opinion will compare on one hand the energy shortages during AES control, when the power outages continued due to non payment, and on the other hand the situation when the Russian company took over and began an uninterrupted supply of electricity to the Georgian population. This mechanism most likely will be used as the political instrument for maintaining Russian control over Georgian sovereignty. According to Dr. Papava, if, after the 2003 parliamentary elections in Georgia, the forces that were not supported by Moscow would gain the majority seats in the Georgian Parliament, Russia might use another scenario: switch off the electricity. The outcome of such a measure would be quite opposite from the previous option. It will create public discomfort and dislike of the Georgian authorities, who would not be able to manage continuous energy crises and electricity outages in the country. This is the real political mechanism that Russia possesses for the violation of Georgia's sovereignty, claimed Dr. Papava.

D. FACTORS INDICATING THE VIOLATION OF GEORGIAN SOVEREIGNTY

This thesis comes to the conclusion that the combined goals of the state and the economic elite of the Russian Federation yield joint Russian policies that violate Georgian sovereignty. How exactly do Russian economic interests violate Georgian sovereignty? Weakening Georgia's independent decision-making capabilities serve the interests of both Russian state and energy conglomerates. For Russian state the violation of Georgian sovereignty is the matter of enhanced political influence in the Caucasus region. For Russian businesses it serves broader prospects of increased economic gains.

In order to understand the full extent of the subject, it should be realized how strongly Russian domestic politics and vested internal interests affect the foreign policy course of the Russian state. A key factor is to acknowledge that the force possessing power domestically is most likely to extend its control over the foreign policy agenda.

From this standpoint, the RAO UESR is a powerful player in Russian domestic politics and as the previous analysis shows, the company management effectively lobbies its interests in the Russian government concerning export policies. Even if these priorities do not fully match those of the state, the policy mechanisms that both the state and the economic elite utilize to achieve their interests in Georgia are identical. Therefore, the force that controls the Georgian energy sector is interested in ensuring its political influence over the Georgian political and economic institutions.

There are multiple ways that the Russian Federation imposes its will on its relatively weak neighbor, and energy policy is one of them.¹³¹ Even if, according to international law, there is no direct violation of Georgian sovereignty through Russian dominance on the Georgian energy market, the challenge for Georgian statehood comes into being when the balance of political power within the Russian federation shows that the state is using the energy policy to seek power abroad. In the given circumstances, when the Russian side currently has its hand on the decision-making process in Georgia with regards to the energy sector, it will be difficult for the latter to implement independent decisions concerning internal energy policies.

The challenge that Russian national interest in the energy sector creates to the Georgian statehood comes down to two main factors: First, it may seem that Russian dominance over the Georgian energy market currently does not necessarily pose an immediate risk to western energy projects in the Caucasus region, where Georgia plays an important role of energy transport corridor. Georgia's central role in the Eurasian east-west energy and transportation corridor is vital to the economic viability of the entire region and its integration with Western political, economic and security structures.¹³² Even so, it does not mean that Russia will not attempt to decrease western influence in the region and aim to get rid of rival projects. Russia's *Nezavisimaya Gazeta* reported, for example, that Moscow had proposed Russia's Blue Stream pipeline (the natural gas

¹³¹ Some other ways that Russia uses in order to impose its will over Georgia include the issue of Russian military bases in Georgia; problems over state border control and terrorism; Russian support to Georgia's separatist regimes in South Ossetia and Abkhazia; status of ethnic Russians living on the Georgian soil. The second chapter of the thesis elaborates these issues in more detail.

¹³² The United States Agency for International Development, "USAID/Caucasus – Georgia Country Strategy: 2004-2008." October 27, 2003. Online. Available at: <<http://www.usaid.org/ge/pdf/FinalDocAbr.pdf>>. Accessed May 19, 2004.

pipeline, running under the Black Sea between Russia and Turkey) be used to transport Azerbaijani gas from the Shakh-Deniz field to Turkey and then on to Europe as an alternative to the construction of the Baku-Tbilisi-Erzurum gas pipeline.¹³³ This particular offer did not have any significant effect on the energy policies of the Caucasus region and neither did the Russian Federation pursue the issue further. However, the statements similar to this clearly indicate that Russian leadership is not willingly giving up its strong geopolitical influence in the Caucasus region. It also shows that Russia will use any opportunity to increase its political influence in the region and make the Caucasus countries, including Georgia, politically and economically dependent on Russia.

Another example of Russia's willingness to influence political and economic developments in Georgia is an "Agreement between the Joint Stock Company Gazprom and the Government of Georgia on Strategic Partnership in Gas Sector," signed July 1, 2003 in Moscow. Article 12 of the agreement says it "enters into force immediately after the signature and stays valid for twenty five years."¹³⁴ Even though, as experts remark, the terms of the Agreement are not binding, it "could be used by the stronger party to coerce the weaker party to acquiesce in positions that were not actually agreed upon."¹³⁵

Russian energy policies pose a serious risk to energy security in Georgia and thus, it is argued, violate Georgian sovereignty. If Russia completely succeeds in pursuing its energy policies in Georgia, and prevents the implementation of western energy projects, Georgia will solely depend on the one source of the energy supplies. The state will not have an alternative inflow of the energy resources that would ensure the balance of interests of the relevant players. Consequently, Russian dominance in the energy sector restricts Georgian independent decision-making capability with regards to the foreign policy and therefore threatens its sovereignty.

¹³³ Anatoly Gordiyenko, "Washington Doesn't Dictate, It Just Recommends, and Asks You To Take Dictation." *Nezavisimaya Gazeta*, June 9, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 21, 2004.

¹³⁴ Ministry of Fuel and Energy of Georgia, "Agreement between the Joint Stock Company Gazprom and the Government of Georgia on Strategic Partnership in Gas Sector." July 1, 2003. Article 12. [Translated by author].

¹³⁵ Cary Young, Attorney and Counselor, PA Consulting Group. "Re: Draft Agreement between GoG and Gazprom," June 28, 2003. Ministry of Fuel and Energy of Georgia, November 20, 2003.

The second factor affected by Russian dominance in Georgia's energy sector is of purely domestic nature but nevertheless is similarly important for Georgian statehood. In theory Georgia has sufficient capacity for generating hydropower to meet domestic needs. Its potential average annual hydropower production capacity is 135.80 billion KWh. Proper exploration of this potential "will not only satisfy the domestic demand for electricity, but will also give an opportunity to export part of generated electricity to foreign markets."¹³⁶ The level of electricity consumption is much lower compared to what the state is capable of producing. According to US Energy Information Administration, in 2002 the consumption level did not reach 7 billion KWh.

In the previous chapters the thesis showed that Russia, through the deal with the AES, the US-based power generating and distributing enterprise, gained ownership of over 30 percent of Georgia's power generation and 60 percent of electricity distribution. Under the current circumstances of Russian dominance, the potential for generating electricity domestically is not likely to be explored. According to Davit Mirtskhulava, the exploration of Georgian energy resources requires huge investments for modernizing current power generating facilities, transmission networks, and dispatch centers. Georgia can become self-sufficient in electricity supplies only if it will channel investments into such modernization programs and construction of new power generating units.¹³⁷ In 1998, the United States Agency for International Development, together with the Government of Georgia, conducted a study to identify the requisite capital investments for Georgia's rehabilitation and development of the electric power sector. The study determined the strategic needs for Georgia's relative energy independence and reliable electricity supply. According to the results of the study, required investments for repairs and modernization of existing power plants and power grids in Georgia reaches nearly 1.5 billion USD.¹³⁸ Under current budgetary constraints and the overall politicization of

¹³⁶ Demur Chomakhidze, *Georgian Energy Safety: Social and Economic Aspects*. Tbilisi, Georgia: Melkadze Scientific Research Institute of Social, Economic, and Regional Problems 2003. pp. 43, 48. [Translated by author].

¹³⁷ Davit Mirtskhulava, Chairman of the Energy Regulatory Commission of Georgia. Tbilisi, November 20, 2003. Interviewed by author.

¹³⁸ United States Agency for International Development, Ministry of Fuel and Energy of Georgia. "Georgia Electricity Sector Least Cost Development Plan," Final Report, Volume 1, Chapter 1. pp. 1-8. September 1998.

the energy issue, the Georgian state is unable to provide necessary financial resources, and domestic private investments are unavailable for rehabilitation of the Georgian electricity sector.

Lack of domestic capabilities to restore the energy sector in Georgia leaves no option other than continuous dependency on energy imports and foreign energy projects in the Caucasus region. During the previous political regime in Georgia, in addition to budgetary constraints there was a lack of political will to develop the domestic power-generating sector. Priority primarily was given to foreign energy projects, both western (oil and gas pipelines) and, during the recent years, Russian (transit routes of Russian gas and electricity to Turkey). Interfax News Agency quoted former Georgian President Eduard Shevardnadze as claiming: "I reaffirm that the North-South track will exist and quickly develop simultaneously with the East-West energy corridor. This position, which meets the strategic interests of Georgia, is absolutely clear and acceptable for our American friends and partners."¹³⁹ Even though participation in international energy projects is extremely valuable for Georgia, it does not solve the main problem that the state faces currently: the problem of state sovereignty in terms of energy security.

E. STEPS FOR REDUCING GEORGIAN DEPENDENCY ON RUSSIA

The concern of current Georgian leadership over the energy sector is explicable. What measures can reduce Georgia's dependency on Russia in the energy sector? The energy sector is an important source of power. It is not an isolated component of statehood and therefore has broader security implications for the state in the international system. The second chapter of this thesis introduced the concept of categorizing the state's energy sector. According to the concept, there are three basic categories to describe the energy sector of the state: import-dependent, self-sufficient, and export-oriented energy sectors. An import-dependent energy sector is poorly supplied with domestic energy resources and largely relies on imports. A self-sufficient energy sector delivers an adequate supply of energy products for domestic consumption. An export-oriented energy sector has the capability of generating excess quantities of energy products and therefore concentrates its activities on export. Each of the categories

¹³⁹ "Shevardnadze wants to broaden energy cooperation with Russia," *Interfax News Agency*. June 9, 2003. Accessed through: <<http://www.nexis.com/research>>. May 21, 2004.

includes different scenarios that have an impact on the state's overall national security. Depending on where the state stands in terms of its energy sector largely determines how effectively it can defend national sovereignty.

As a point of departure for the analysis, this thesis assumed that because currently Georgia is not producing sufficient quantities of energy supplies domestically and largely relies on imports from the Russian Federation, the categories of import-dependent versus export-oriented energy sectors would be assigned to Georgia and Russia, respectively. This thesis showed how Russia, through its energy policies, undermines Georgian sovereignty and attempts to regain political control over the Caucasus region.

What policies could the state with an import-dependent energy sector implement in order to increase its energy security vis-à-vis the state with an export-oriented energy sector? There are several policy options available for consideration. Each of them has a certain impact on the state's sovereignty. The following table shows a brief summary and the rest of this chapter discusses three policy options.

	Impact on National Sovereignty	Occurrence Likelihood
Maintain Status Quo	Negative	High
Diversify Supply	Positive	High
Import Substitution	Positive	Low

Table 1. Policy Options

1. Policy option #1: Maintain the Status Quo

One option for the state with an import-dependent energy sector to deal with vulnerability in terms of its energy supplies is to maintain status quo. Any major revision in a pattern of import-export transactions in this option is unlikely. The scenario assumes that for a considerable period of time the import-dependent energy sector will rely on exports from a single supplier of energy products. Long-term prospects for the state with an import-dependent energy sector are not very optimistic. A shortage in domestic production capabilities and the lack of alternative sources of energy supplies makes it extremely vulnerable to the political intentions of the supplier state.

Georgia's continuous dependence on Russian energy supplies has a negative effect on Georgian statehood. Russia will remain the only strategic supplier of energy products until new western pipelines are completed. But the completion of Baku-Tbilisi-

Ceyhan (BTC) and Baku-Tbilisi-Erzurum (BTE, or South Caucasus pipeline) transit pipelines does not necessarily fill the existing gaps in Georgian energy security. These projects will bring benefits to Georgia in the form of revenues for transit, which are expected to be approximately 500 million USD, and 5 percent of transported gas that will remain in Georgia free of charge.¹⁴⁰ These quantities of energy products might not correspond to increased Georgian demands. The current rate of growth of the Georgian Gross Domestic Product (GDP) is 5.4 percent.¹⁴¹ If the country's economy continues to grow and industrial development takes off, Georgian demands for energy supplies will increase as well. As long as Russia remains the major supplier of energy products for Georgia, reliance of the Georgian economy on Russian supplies will increase. This, in turn, makes Georgian sovereignty extremely vulnerable against political aspirations of the Russian Federation.

2. Policy option #2: Diversify Supply

A second option for the state with an import-dependent energy sector is to diversify the sources of supply. The state has to introduce a third player into the local energy market: another state with an export-oriented energy sector. The competition among these export-oriented energy actors for the energy market of the state with import-dependent sector generates three positive effects: 1) the market will create supply alternatives; 2) it will produce diversity of policies; and 3) will possibly reduce the prices of the product for consumers. In broad political terms, the state that is weak relative to other states in certain sources of power and whose domestic political stability depends on foreign resources has to follow foreign policy goals, which balance interests in the region. This policy option does not solve the basic problem for state sovereignty, i.e. it does not "exclude external actors from domestic authority configurations," but

¹⁴⁰ See: "250-Mln Funding for BTC Pipeline," *Interfax News Agency*. Central Asia & Caucasus Business Report. November 10, 2003; "Georgian Leader - Georgia Considering Cooperation Within CIS Free Trade Zone," *BBC Monitoring International Reports*. September 22, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 21, 2004.

¹⁴¹ Source: Central Intelligence Agency, "World Factbook 2003." Online. Available at: <<http://www.cia.gov/cia/publications/factbook/index.html>>. Accessed May 21, 2004.

nevertheless it considerably reduces one's vulnerability to the threats posed by the dependence on a single outside source.¹⁴²

Existing trends indicate that currently there is a little competition on the Georgian energy market. Western energy projects are underway, but their completion is still a matter of the future. Construction of the Baku-Tbilisi-Ceyhan (BTC) pipeline began in April 2003 and will reach full capacity only by 2010, when it will be capable of transporting up to 1 million barrels/day. The South Caucasus gas line (BTE), running from the offshore Shah Deniz gas field in Azerbaijan to Turkey will begin operations in 2006.¹⁴³ In contrast, Russian energy giants RAO UESR and Gazprom already operate and deliver energy supplies to Georgia. In 2003, Georgian imports of electricity and gas reached 435 MW/day and 1.009 billion cubic meters of gas, respectively.¹⁴⁴ This fact gives huge comparative advantage to Russia on the Georgian energy market. When the BTC and BTE pipelines become operable and reach their full capacity, it will produce competition on the Georgian energy market. Georgia will have an alternative to choose the supplier of oil and gas that offers more beneficial terms of supply depending on the price, quality of supplied energy product, and reliability of supplies. Possible developments in the electricity sector also suggest further alternatives. Georgia's immediate neighbors have surplus electricity production (see Figure 1). This policy option offers Georgia an opportunity to direct its diplomatic efforts in order to develop import-export relationships with neighboring countries other than the Russian Federation.

¹⁴² Stephen D. Krasner, *Sovereignty: Organized Hypocrisy*. Princeton, New Jersey: Princeton University Press, 1999. p. 9.

¹⁴³ "Energy Concerns Cannot Constrain U.S. Policy, Larson Says: U.S. must have access to energy on terms supporting economic growth," *Federal Information and News Dispatch*, US Department of State. April 8, 2003. Online. Accessed through: <<http://www.nexis.com/research>>. May 21, 2004.

¹⁴⁴ See: "Georgia increases imports of Russian electricity," *RosBusiness Consulting Database*, RBC Network Corp. February 10, 2004; "Gazprom, Georgian Fuel Ministry Discuss Gas Supplies," *Interfax News Agency*. March 10, 2004. Online. Accessed through: <<http://www.nexis.com/research>>. May 22, 2004.

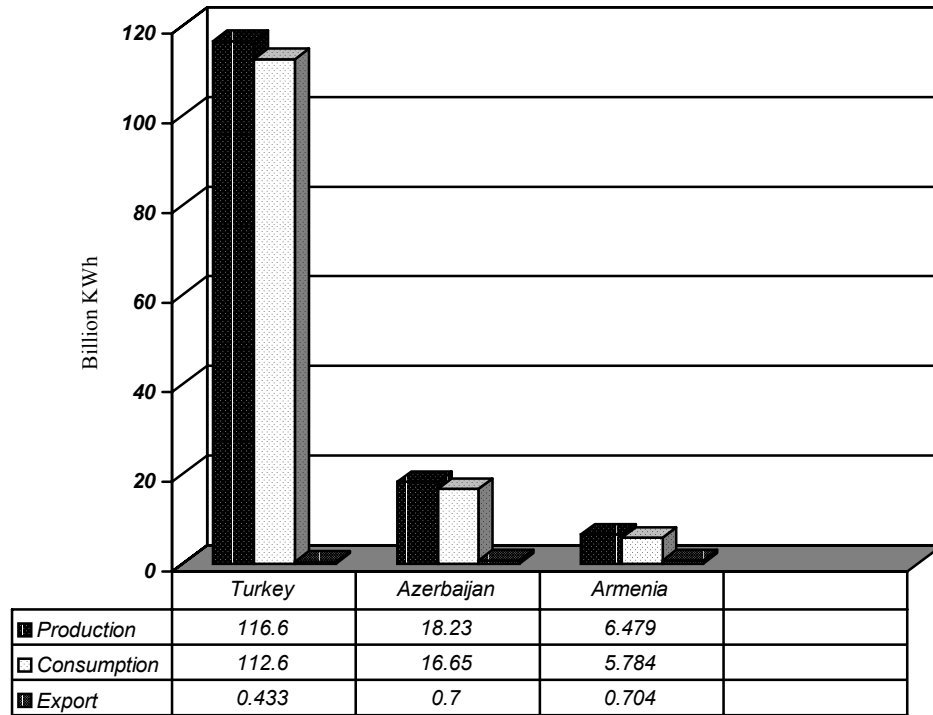


Figure 3. Potential Suppliers of Electricity to Georgia
 (Source: Central Intelligence Agency. World Fact-book 2003. Available online at: <http://www.cia.gov/cia/publications/factbook/index.html>. Accessed May 22, 2004.)

In sum, by introducing new players into the local energy market, Georgia can achieve economic as well as political benefits. Diversifying sources of supply will allow the market to set fair prices on energy products. Increasing the number of players will facilitate creation of favorable conditions for better energy security of the state. Nevertheless, this policy option does not solve the problem associated with Georgian national sovereignty. It does not prevent foreign players from making decisions on behalf of Georgian interests. In this scenario Georgia's sovereignty, to a lesser degree, still remains vulnerable to political intentions of foreign powers, including Russia.

3. Policy option #3: Domestic Import Substitution

The third option for the state with an import-dependent energy sector is a shift in the category. In general, it means that to decrease reliance on foreign energy suppliers the state has to develop its energy sector in a way that it either will provide sufficient quantities of energy supplies for domestic consumption, or in addition, it will have a surplus in the production. In this case, the state with an import-dependent energy sector

alters its status and becomes either self-sufficient in energy supplies, or its energy sector develops into export-oriented category. Such a shift becomes possible only if the state possesses the potential for producing domestic energy products (gas, oil, electricity generation capacity). At the same time, it is a major shift in the state's international status. Eliminating a state's dependency on foreign energy supplies considerably decreases threats to national sovereignty. Therefore, development of the domestic energy sector has huge political significance for the state.

This policy option could be most beneficial for Georgia, but at the same time it is the most difficult scenario to implement. Despite few domestic oil and gas resources, Georgia possesses enough hydro-power capacity to guarantee a reliable supply of electricity throughout the country.¹⁴⁵ Adequate rehabilitation of existing hydro-power plants and further development of generation capabilities could eliminate the need to import electricity from abroad. At a minimum, Georgia would be able to produce sufficient quantities of electricity for domestic consumption. Further expansion of the Georgian electricity sector could enable the state to export the product on foreign markets. The problem with domestic generation of electric power, as previously discussed, is the lack of political will and financial investments. Rehabilitation of the electricity sector requires considerable investment (nearly 1.5 billion USD) not available from domestic sources. No international investors are presently interested. The previous government of Georgia did not put enough efforts into rehabilitation projects. With the 'Rose Revolution' in November 2003, and the Georgian presidential elections in January 2004, it is too early to evaluate the views of the current Georgian leadership on the development of the energy sector. So far, the new Georgian government has not altered the earlier strategy of cooperation with Russia and participation in western energy projects. Current statements indicate that the Russian presence on the Georgian energy market is unlikely to decrease. On the contrary, the newly elected President of Georgia expressed his support for a Russian plan to construct a new oil pipeline from Russia's

¹⁴⁵ For data see: US Energy Information Administration, "Caucasus Region Country Analysis Brief." October 2003. Online. Available at: <<http://www.eia.doe.gov/emeu/cabs/caucasus.html>>. Accessed June 9, 2004.

Novorossiysk to Georgia: “We greet the building of an oil pipeline from Novorossisk to Georgia that runs parallel to the Baku-Tblisi-Ceyhan pipeline.”¹⁴⁶

The shift from import-dependent to self-sufficient energy sector is an extremely costly project that requires long-term commitment by the Georgian state. Nevertheless, the political benefits that this policy option is capable of bringing to Georgia’s sovereignty are worth the costs required for rehabilitation of domestic energy sector. The development of domestic power production capabilities would enable the Georgian state to be free from dependence on Russian energy supplies and Georgian sovereignty would not be threatened by Russian energy politics.

¹⁴⁶ Press Center of the President of Georgia, “Saakashvili supports alternate pipeline to BTD pipeline.” February 10, 2004. Online. Available at: <<http://www.president.ge/englishversion/pages/Saakapipeline.html>>. Accessed May 22, 2004.

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